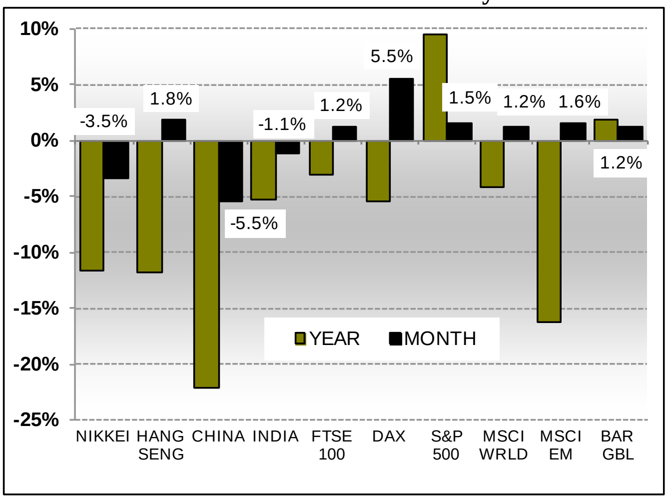
MAESTRO
# INTERMEZZO
Investment Letter | 12th Edition | August 2012

**July in perspective – global markets**

At the risk of repeating myself for the umpteenth time this year, July "proved to be another remarkable month". Full of volatility, contradictions, inexplicable movements in some assets and not without controversy and the odd casualty (yet again!), markets bumped their way into positive territory, with the odd exception. The gains come after a profitable month in June although you will recall that May's returns were uniformly negative. Despite concrete evidence of the economic growth slowing in virtually every area of the world and no solution being found to the current debt-induced woes in the Eurozone and US, equity markets led the charge. The MSCI World index rose 1.2% and, for the first time in a while, the MSCI Emerging market index rose by an even greater degree, ending 1.6% higher on the month. The German market was particularly strong, rising 5.6%, bringing its year-to-date return to a remarkable 14.8%. What crisis in Europe, I hear you say. Emerging markets endured a month of mixed returns; the Indonesian market rose 4.7% and Brazil 3.2% but India fell 1.1% and China 5.5%. The Chinese market has now declined 22.1% over the past year, in stark contrast to the US market, which has risen 9.5% over the same period. The bond market enjoyed another strong month, rising 1.2%. The dollar firmed against most currencies as investors continued to seek refuge in the "safety" of the greenback.

**Chart 1: Global market returns to 31 July 2012**

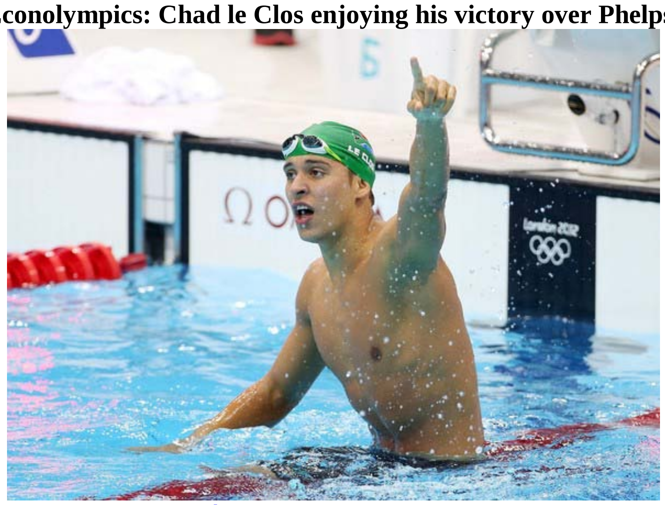



**What's on our radar screen?**

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

- *The SA economy:* The SA Reserve Bank (SARB) cut interest rates by 0.5% at their July meeting, placing the repo and prime overdraft rates at 5.0% and 8.5% respectively. While many were surprised by the rate cut internally i.e. within our own thinking, we had placed a 60:40 probability of a rate cut, so were not entirely surprised by the cut. The SARB also cut its SA growth forecasts for 2012, 2013 and 2014 to 2.7%, 3.8% and 4.1% respectively, although it signalled that further downside exists to these forecasts, concerns about the effects on SA of the European crisis and the global slowdown being the main reasons behind the revisions. The good news came in the form of a reduction in its inflation forecasts to 5.6%, 5.1% and 5.1% for 2012 – 14.
- *The UK economy* shrank 0.7% in Q2, versus declines of 0.3% and 0.4% in the preceding two quarters; although the construction sector led the downturn, declines were evident in the service and production sectors of the economy. Consensus expectations were for a decline of 0.2%.
- *The US economy*: slowing growth is a feature of the world right now and it is no different in the US. There, the economy grew only 1.5% during Q2, down from 2.0% and 3.0% in the preceding two quarters. The unemployment rate rose to 8.3% and job creation remains anaemic.
- *Emerging economies*: Chinese second quarter (Q2) growth slowed to 7.6% at an annual rate from 8.1% in Q1. Retail sales grew 13.7% year-on-year.

**Econolympics: Chad le Clos enjoying his victory over Phelps**



Source: [www.zimbio.com](http://www.zimbio.com)

**What makes the current market behaviour so weird?**

Maestro clients can be forgiven for thinking the Maestro "record is stuck". Each month we begin the monthly letter that accompanies client statements with words to the effect that, the month was an extraordinary, or unique, remarkable, etc. True to form our July letter began in similar fashion, so I thought it would be worth sharing some of the reasons – and this list is by no means comprehensive – why we keep on qualifying the market behaviour as such. Consider the following then, many of which are rather contradictory:

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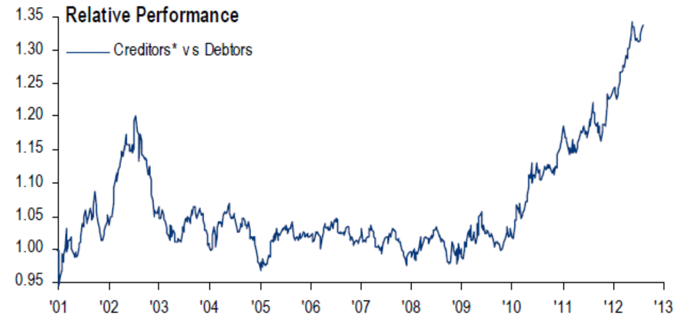
- The global economy is slowing down, with the US heading for a possible recession and Europe probably there already. Yet the year-to-date return for the US equity market is 11.3% and the German market is up 14.8% over the same period.
- The equity market of the fastest growing economy on the planet, China, is down 22.1% over the past year and 4.4% for the year-to-date.
- The massively over-indebted US economy's share market has risen 9.5% over the past year while the share market of the economy with the strongest balance sheet by far and with net reserves of some $3.5 trillion (trn), China, has declined 22.1% over the same period.
- Yet despite this, countries with a current account surplus i.e. creditor nations, continue to outperform debtor nations i.e. those which run current account deficits – refer to Chart 2 below.

**Chart 2: Creditor nations continue to outperform debtor nations**

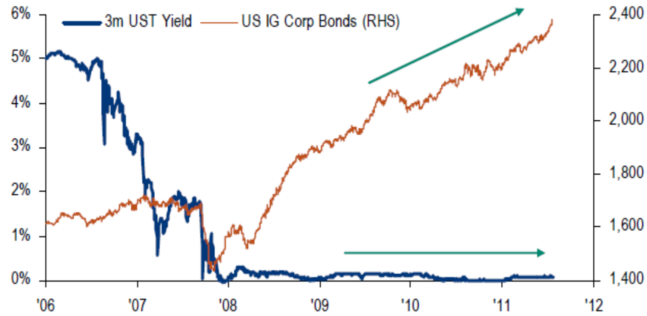



*Creditors defined as countries with current account surplus = equal-weighted basket of Saudi, Austria, Denmark, Hungary, Korea, Japan, China, Philippines, Russia, Germany, Sweden, Netherlands, Taiwan, Malaysia, Switzerland, Singapore, Norway, Mexico
Debtors defined as countries with current account deficit = equal-weighted basket of Portugal, Turkey, Greece, Poland, New Zealand, Italy, S Africa, Czech, Spain, India, France, Israel, Ireland, UK, Brazil, Canada, US, Australia, HK, Thailand, Indonesia
Note: total returns ($ terms)

Source: Merrill Lynch

- An increasing number of developed countries now have a negative yield on their 2-year bonds i.e. investors are paying governments to hold their debt. Clearly that dooms those investors to negative returns in both absolute and real terms. Where is the logic in that?
- More specifically, eight central banks now have policy rates at or close to zero (Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Japan, Netherlands, Singapore, Switzerland, UK and US). Thirteen countries have bond yields with maturities out to 2 years, which are effectively at zero. These 13 countries are heavily populated (715m) and heavily market capitalized ($32trn of bonds and $31trn of equities) neighbourhoods of substandard growth. Surely this situation will eventually turn into the next bubble? Specifically in high-yielding bonds? Note from Chart 3 how the issue of high-yielding bonds has mushroomed since the world of ZIRP (zero interest rate policy) dawned.

**Chart 3: The world of ZIRP and high-yield bond issuance**




Source: Merrill Lynch

- No less than 9 central banks reduced their official interest rates in July alone.
- The rand declined 18.3% against the dollar over the past year, yet the basic material (resource) sector, which is traditionally supported by a weak rand, is down 8.7% over the past year.
- A weak rand is traditionally bad for banks, but the SA financial sector has risen a remarkable 30.9% in the past year, ahead of the traditionally more reliable and less volatile industrial sector, which itself has been no slouch – it is up 25.8% over the past year.
- All of which means that there is an astonishing 39.6% differential between SA basic material and financial sectors in the space of just twelve months. To the best of my knowledge, that differential has never been that large, yet, for what it is worth, we (Maestro) are still advocating an underweight position in resources shares and an overweight position in industrials.
- But the differentials occur even within the sectors. Anglo for example, declined 9.2% in July (admittedly on the back of poor results) while Billiton rose 2.8%. Billiton is down 3.6% over the past year while Anglo is down 23.1%.

These are but some of the reasons why we continue to describe current market behaviour as "extreme" and unusual.

**Some quotes to chew on**

*Greedy bankers versus corrupt and inept politicians.*

In a most entertaining discourse on the topic of greedy bankers, entitled *Morals and Money*, *SIM Global Financial Fund manager* (and industry legend, I should add) *Kokkie Kooyman*, had the following to say in response to SA Finance Minister Pravin Gordhan's recent description of banks and financial institutions as "greedy monsters":

"Back to Pravin Gordhan: Reading about this criticism of bankers, I wondered what Mr Gordhan's opinion is of politicians. Just this week the Spanish high court overruled political objections to investigations probing the role politicians played in the Spanish banking losses whilst the probe into Fannie Mae and Countrywide revealed that bank executives gave discounted loans to politicians to ensure votes for the continuation of practices which cost taxpayers hundreds of billions. Irish politicians were big beneficiaries of the strong loan growth of the Irish banks whilst taxpayers have to pay and suffer afterwards. It would be an interesting study to see what has cost taxpayers more: corrupt practices of and theft by politicians or high bank fees". We couldn't have said it better!

**Econolympics: The Politician's approach – take 1**

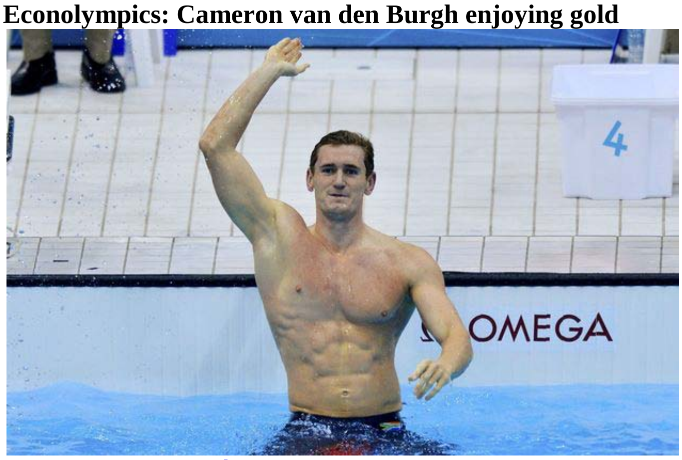

Source: Ingram Pinn, FT. com

*Financial repression: Investing turned upside down*
In a special report under the abovementioned title, *Deutsche Bank* recently summarized its contents as follows: "A stealthy 'regime change' has unfolded in the developed world and most emerging markets. This regime is "financial repression", loosely defined as the public sector commandeering resources from the financial system on attractive terms, preferably at negative real interest rates. Eventually all debt turns out to be contingent government debt. Financial repression simply spreads the burden sharing to savers by confiscating their wealth with negative real rates".

*Extraordinary low yields won't meet long-term expectations*
US-based *Blackrock* is the world's largest investment manager, with a mind-boggling $3.6 trn dollars (that's a cool R30trillion!) under management. In their recent results *CEO Larry Fink*, whose comments are always closely watched, noted that business was more cautious than normal. Slowing growth in China and the turmoil in Europe had shaken the confidence of investors worldwide, he said. CEOs have contracted their field of vision. Fink went on to warn that Europe's debt problems would take five to eight years to fix, while the US faced the uncertainty of the fiscal cliff, with tax rates due to kick in automatically, after elections in November without political action. He also said that havens such as US and German government debt could prove illusory. "Extraordinary low yield levels cannot meet the long-term return expectations of anyone".

*We will do whatever it takes!*
One of the defining moments in the markets in July and one which turned markets around dramatically, was the speech given by *European Central Bank governor Mario Draghi* at an investment conference in London just ahead of the Olympics. It is worth looking at some extracts from that speech. "I asked myself what sort of message I want to give to you; I wouldn't use the word 'sell', but actually I think the best thing I could do, is to give you a candid assessment of how we view the euro situation from Frankfurt... The first message I would like to send, is that the euro is much, much stronger, the euro area is much, much stronger than people acknowledge today... The second message I would like to send today, is that progress has been extraordinary in the last six months. If you compare today the euro area member states with six months ago, you will see that the world is entirely different today, and for the better... But the third point I want to make is in a sense more political. When people talk about the fragility of the euro and the increasing fragility of the euro, and perhaps the crisis of the euro, very often non-euro area member states or leaders, underestimate the amount of political capital that is being invested in the euro. But there is another message I want to tell you. *Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough* (my italics)...There are some short-term challenges, to say the least... I think I will stop here; I think my assessment was candid and frank enough.

**Econolympics: Cameron van den Burgh enjoying gold**




Source: www.sportlive.co.za

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## The makings of our next Big Picture Theme

Clients will know - as we frequently allude to them - that we maintain a list of what we call **Big Picture Themes**; ideas or themes, which develop slowly but which are very powerful in fashioning the direction and behaviour of global markets and economies. Our Big Picture Themes guide our thinking, provide a useful list against which to measure our long-term investment views and actions, and serve to highlight major risk areas we need to keep a wary eye on.

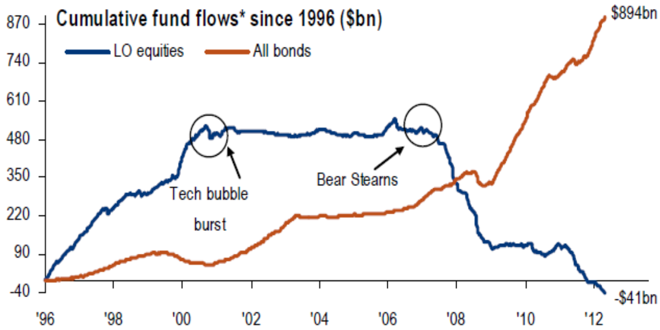
For some time now we have (internally) been discussing creating a new theme, which, although hard to imagine in the current market circumstances, we think will come to play an important role in the direction of global equity markets over the next decade. The theme is *The Great Rotation* which refers to the *lack* of equity exposure global investors currently have. Trillions of dollars have poured into bonds, which will neither deliver attractive long-term returns over the next decade nor in any way lead to long-term capital growth, which is what the developed world desperately needs from its investment portfolios, given the powerful demographic forces at work against them (less working people providing for more older and retired people). We are not alone in identifying this theme although no one is really touting it too loudly because such an action would be rather premature. However, we would do well to acknowledge it.

Merrill Lynch recently placed the current market developments into wonderful context and simultaneously provided a better backdrop to *The Great Rotation* than we could ever do. Here it is: "Financial markets made a lot of history in the first half of the year... we are currently experiencing multi-century lows in many developed market government bond yields, the cheapest European equity market in almost a century, and the last throes of the biggest bear market in US real estate since the early 1990s.

The success of global central bank's 'war against inflation' in the early 1980s set the stage for an end to the great bear market in bonds. Since then, we have experienced an extended period of lower-than-expected inflation, lower-than-expected interest rates, and a secular bull market in credit. A long series of financial crises and geopolitical shocks – from the fall of the Berlin Wall, Japan's lost decade(s), The Tequila and Asian crises in the 1990s, and China's acceptance into the WTO – together reinforced the primary trend of lower and lower interest rates.

Over the last 30 years we have experienced three major bull markets: equities (1982 – 1999), US real estate (1997 – 2006) and bonds (1981 – today). The long boom in real estate, credit and growth came crashing to an end in 2007 as the collapse of two Bear Stearns hedge funds marked the end of easy credit. Since that moment five years ago, banks across the developed world have been in retreat. The current Era of Deleveraging has induced year after year of low growth and still lower interest rates.

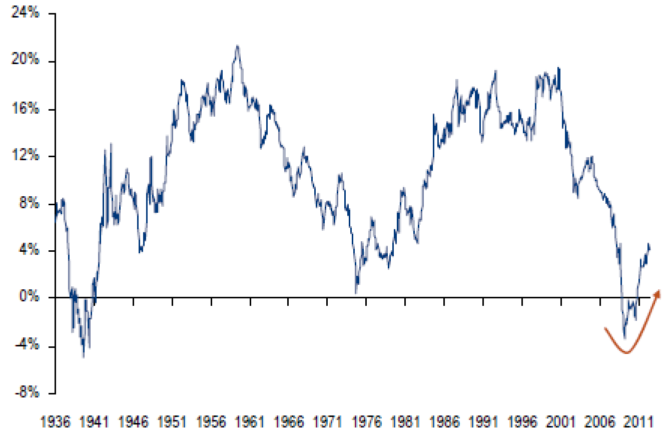
**Chart 4: Investors have flocked to bond funds**




Source: Merrill Lynch

Over this period investors have decisively flocked to fixed income and shunned equities – refer to Chart 4. But thanks to an epic policy response to the Great Financial Crisis, both global equity and commodity prices have posted handsome gains in recent years. Since the market lows in March 2009, the full float market cap or global equities has jumped $22trn to a total of $48trn, aided in no small part by a doubling in the size of central bank balanced sheets and forex reserves (to $20trn) and zero interest rate policies in the US, Europe and Japan.

**Chart 5: US large cap (equities) 10-year rolling return**




Source: Merrill Lynch

But while investor positioning and bullish monetary policies have allowed risk assets to rally in recent years, the true bull markets have been confined to assets that provide investors with Growth, Yield and Quality. The (Merrill Lynch) asset allocation is likely to remain skewed to these themes until the current war against deflation is won and the global

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economy is on firm enough footing that the market can start pricing in higher bond yields.

A good rise in bond yields will help usher in a shift in fund flows from fixed income to equities. While the (Merrill Lynch) base case is that this Great Rotation is tantalizingly close as the allure of fixed income fades with diminished expected returns, the passion for equities among private investors will remain cool until decisive resolutions to US and European fiscal problems and a marked improvement in US labour and housing markets occur".

**Table 1: Equity total returns by country (in US dollars)**

| Country | 10 year Annualized Return (%) | Average Annual Return since 1926 (%) |
|---|---|---|
| EM | 13.1 | 12.1 |
| Germany | 6.3 | 13.7 |
| UK | 5.3 | 12.0 |
| US | 4.1 | 11.8 |
| France | 4.0 | 12.3 |
| Japan | 1.8 | 11.9 |

Source: Merrill Lynch

### For the record

Table 2 lists the latest returns of the mutual funds under Maestro's care. You can find more detail by visiting our website at [www.maestroinvestment.co.za](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](our website).

**Table 2: The returns of funds under Maestro's care**

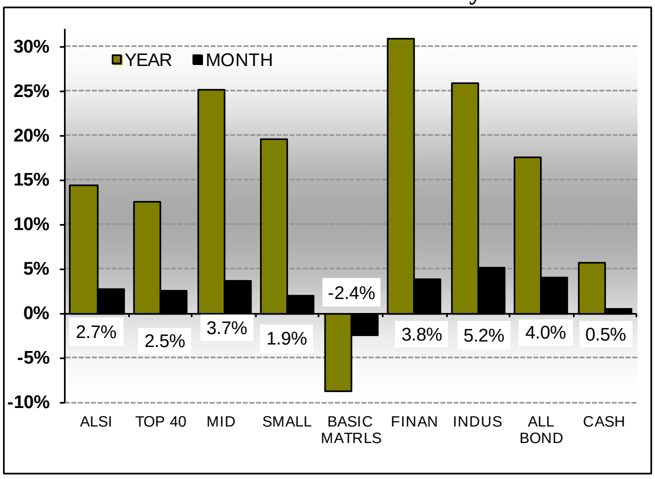
| | Period ended | Month | Year to date | Year |
|---|---|---|---|---|
| **Maestro Equity Fund** | **Jul** | **2.0%** | **11.5%** | **12.8%** |
| *JSE All Share Index* | *Jul* | *2.7%* | *10.0%* | *14.5%* |
| **Retirement Funds** | | | | |
| **Maestro Growth Fund** | **Jul** | **2.0%** | **9.1%** | **12.5%** |
| *Fund Benchmark* | *Jul* | *2.5%* | *9.0%* | *14.8%* |
| **Maestro Balanced Fund** | **Jul** | **2.0%** | **8.5%** | **12.0%** |
| *Fund Benchmark* | *Jul* | *2.3%* | *8.4%* | *13.9%* |
| **Maestro Cautious Fund** | **Jul** | **2.1%** | **8.9%** | **11.9%** |
| *Fund Benchmark* | *Jul* | *2.2%* | *7.9%* | *12.0%* |
| **Central Park Global Balanced Fund ($)** | **Jun** | **-0.8%** | **2.4%** | **-9.5%** |
| *Benchmark** | *Jun* | *0.0%* | *0.7%* | *-4.3%* |
| *Sector average *** | *Jun* | *1.7%* | *2.0%* | *-6.2%* |

* 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 ($)

### July in perspective – local investment markets

What little respite the basic material (resource) sector enjoyed in June (+2.2%)was all but annulled in July, after that index posted a 2.4% decline, bringing its annual return to -8.7%. While this in itself might be understandable in light of all risk prevalent in the environment, this negative return can be contextualized by the respective 30.9% and 25.8% returns of the financial and industrial sectors over the same period. The 39.6% differential between the resource and financial sectors in one year is absolutely remarkable. We commented on it when it exceeded 20% and again at the 30% mark, at which many would have thought it was unlikely to increase. Now it is close to the 40% level – and that, in only one year. Despite the 2.4% decline in the basic material sector, the All share index still posted a 2.7% return for the month, thanks to the powerful 5.2% gain in the industrial sector. Although some of the industrial heavyweights led the gains (AVI rose 18.2%, Aspen 15.3%, Bidvest 9.0%, Tiger Brands 8.7%, SAB Miller 7.7%) the mid cap index still managed to post the largest monthly return across the market cap spectrum. Large caps, pulled lower by large miners (Amplats -12.3%, Exxaro -11.3%, Anglo -9.2%, Kumba -6.1%) rose 2.5% while the mid cap index rose 3.7%, thanks to the strong returns of the retailers (Truworths 15.4%, Foschini 11.3%, Mr Price 10.1%). Small caps rose 1.9%, bringing the year-to-date returns for the large, mid and small cap indices to 8.4%, 18.4% and 14.6% respectively.

**Chart 6: Local market returns to 31 July 2012**




The All bond index posted a healthy 4.0% return, spurred on by the 0.5% reduction in interest rates during the month. The rand declined marginally against the dollar and the All gold index rose 2.9% although its year-to-date return remains low, at -14.3%. On the equity market the best performing sectors were the electronic and electrical equipment sector, up 13.5%, pharmaceuticals up 12.2% and general retailers

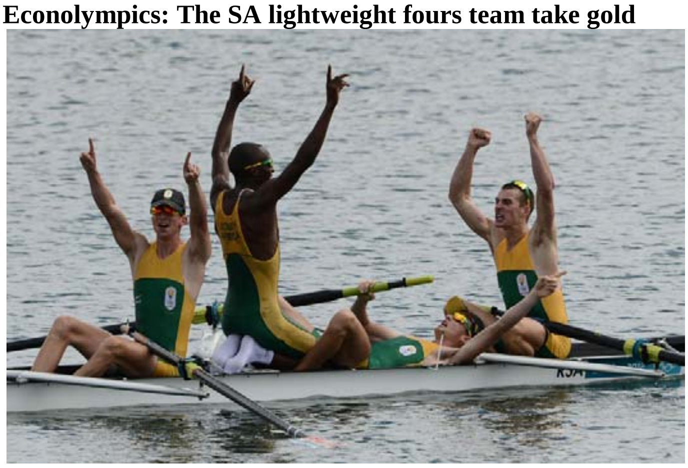
10.1%. Not surprisingly resource shares led the declines; the coal sector fell 12.2%, industrial metals 8.6% and platinum mining 6.4%.

### File 13: Information almost worth remembering

*Good reason to cheer*

Continuous learning is an aspect of the Maestro culture that is well and truly inculcated within our organization. Not only are we learning a great deal all the time about the world in which we live and the markets in which we manage money – which are changing at an unprecedented pace – but we also appreciate the huge effort that is required to study part-time. So you can imagine the joy we felt when we saw that the legendary SA musician Sipho Hotstix Mabuse completed his matric – at the age of 61! Mabuse enrolled in adult classes after dropping out of school in the 1960s. He wrote English, history, geography, business economics, accounting, technology and Sesotho. What a glorious achievement for one who never had half the opportunities most of us had. When asked on how he felt about his achievement, he explained that he is truly happy and feels good about it. "I needed my matric to feel complete even with all my musical success. 45 years out of class is no child's play," he tweeted. From here he intends going to university to study Anthropology as a means of empowering himself educationally. We salute and honour Hotstix for this fine achievement and for the inspirational example he has set for everyone to follow, particularly those less than half his age.

### Econolympics: The SA lightweight fours team take gold

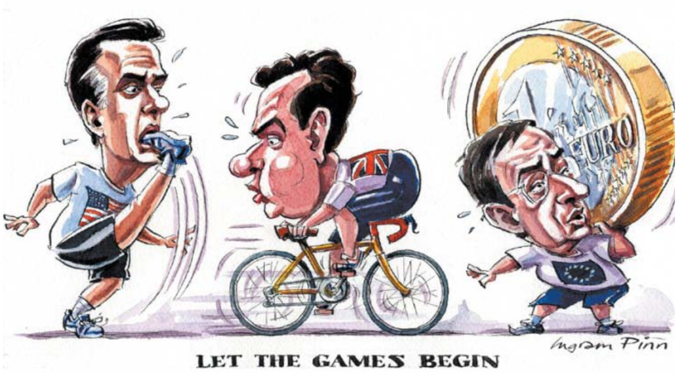


Source: www.emirates247.com

*Emerging market healthcare*

I came across an interesting statistic in a recent Merrill Lynch report into emerging market healthcare, which they are touting as one of their ten thematic investment ideas. Suggesting that emerging market healthcare is an attractive long-term investment theme, they note that although China's healthcare spending has skyrocketed over the past 20 years, it is still low compared to the rest of the world. *Per capita healthcare spending is just $218 in China versus $8 224 in the US*! Clients would know that Aspen has long been one of the largest holdings in our local equity portfolios and although not amongst the largest holdings, we have also held Novartis and Roche in our offshore portfolio (in Central Park Global Balanced Fund) for many years. All these investments have worked well for us – particularly Aspen - and we expect them to continue to do so into the future.

### Econolympics: The Politician's approach – take 2




Source: Ingram Pinn, FT. com

*Can someone please explain?*

Perhaps I am missing something, but I was rather perplexed and concerned to read that SA's Industrial Development Corporation (IDC) had, together with PPC, invested R175m in the Habesha Cement Share Company in … wait for it … Ethiopia. PPC invested R100m while the IDC committed R75m. Perhaps more disturbing was their announcement that investment was part of a plan to build a R1bn cement manufacturing plant in Ethiopia. Now, in its defense, the IDC's mission lists as its primary objective "to contribute to the creation of balanced, sustainable economic growth in South Africa and on the rest of the continent" but to be honest I fail to see how the use of SA taxpayers money (the IDC is a state institution reporting into the Department of Economic Development) can best serve its citizens by creating a competitor on the other side of the continent. Perhaps I am missing something, but I really would have thought they could find more worthy investments in South Africa that would *really* contribute to the development of SA industry! The latter needs all the help it can get in this competitive world.

*Eskom monopoly: rewarding inefficiency, making SA poorer*

Some of you might have seen the thought-provoking article with the above-mentioned title, written by *Investment Manager Chris Logan* about the nature of Eskom's recent performance and proposed tariff increases. Here are a few excerpts of the article. "Alarm bells should be ringing regarding state-owned monopoly Eskom's plans to nearly double the price of electricity (between) 2012 and 2017... The dramatic 159% increase in electricity prices over the last four years to March 31 resulted in electricity now being a very significant cost for nearly all consumers. ...For example platinum producers, those that have not shut down, currently have electricity costs of up to 17% of total costs. ...To cover its rampant costs and achieve its desired profitability and debt levels, Eskom has to secure dramatic electricity price increases. In the process the consumer gets decimated and has no alternative, as Eskom is a monopoly. (Eskom's) primary energy costs have increased by 153% over the past four years to R46bn. Dominant factors at play were the cost of coal burnt, which has increased significantly, and an environmental levy, which is paid to government, has amounted to R14.9bn since it came into being in 2010. Employee benefit costs have increased by 76% over the past four years to R20bn. They would have been significantly higher had R11bn of costs not been capitalized to fixed assets since 2010. Employee numbers have increased 23% to 43 473 in 2012. As electricity sales were flat over this period, *employee productivity fell by 23%, yet average total cost per employee increased by 60% to R500 000* (my italics). Eskom rewards poor productivity with massive increases."

**Table 3: MSCI returns to 31 July 2012 (%)**

| | Jul'12 | 2012 |
|---|---|---|
| Singapore | 7.6 | 21.3 |
| Australia | 7.4 | 8.6 |
| New Zealand | 7.2 | 12.1 |
| Pakistan | 6.1 | 17.1 |
| Indonesia | 5.6 | 0.2 |
| Israel | 4.2 | -3.8 |
| Turkey | 3.9 | 30.3 |
| Korea | 3.6 | 8.2 |
| AP ex-Japan | 3.5 | 7.3 |
| Hong Kong | 3.5 | 9.5 |
| Egypt | 3.3 | 36.5 |
| Malaysia | 3.0 | 6.0 |
| South Africa | 3.0 | 6.2 |
| Russia | 2.6 | 1.1 |
| Thailand | 2.6 | 15.3 |
| EEMEA | 2.2 | 6.1 |
| Mexico | 2.1 | 15.6 |
| Philippines | 2.1 | 26.7 |
| Colombia | 1.8 | 16.9 |
| **MSCI EM** | 1.6 | 3.9 |
| EM Asia | 1.6 | 5.2 |
| Brazil | 1.4 | -8.2 |
| China | 1.3 | 2.7 |
| LatAm | 1.3 | -1.0 |
| **MSCI DM** | 1.2 | 5.7 |
| Hungary | -0.6 | 9.3 |
| India | -0.7 | 6.8 |
| Taiwan | -1.3 | 2.3 |
| Czech Republic | -2.4 | -9.7 |
| Japan | -2.4 | -0.5 |
| Poland | -3.8 | 5.0 |

Source: Merrill Lynch