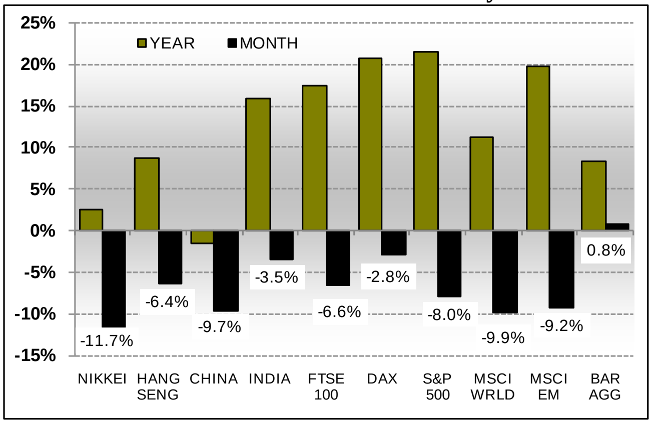
MAESTRO INTERMEZZO
Investment Letter | 10th Edition | June 2010

May in perspective – global markets
Just as investors began assuming that it was back to normal Mr Market parked a 9.9% and 9.2% decline in the MSCI World and Emerging market indices on their doorstep. The US market ended down 8.0% to register its worst May since 1962 (the Dow Jones had its worst May since 1949). Other notable decliners included China, down 9.7% and Russia 12.0%, while in the developed world Japan ended 10.7% lower and Hong Kong 6.4%. Germany held up relatively well, ending down only 2.8%, deriving substantial benefit from the 7.3% decline in the euro against the dollar. There were so many features on the markets during the month, I could never cover them adequately in one paragraph; suffice to say that the issue of Sovereign risk ranked first in terms of influential factors that rattled the markets. Despite a $1 trillion package announced by European authorities, question markets still linger over the likes of Greece, Portugal, Spain and Italy, specifically their ability to get their financial houses in order.

Chart 1: Global market returns to 31 May 2010



Not far off the list of influential factors was the frightening collapse on 6 May of the US equity markets within the space of 10 minutes, only to recover from their decline in the next 10 minutes to end the day 3% lower. Perhaps the most significant issue emanating from the whole debacle, which has since been dubbed the "Flash crash" by the media, is that despite all efforts by authorities and market officials alike nobody yet knows what took the markets down 10% in the space of just ten minutes. Crazy deals went through, like Accenture falling to 1 cent – and trading there! (*Ed:* I wonder what the shareholder/client whose shares were sold at that level felt like.) Thanks in part to a strong dollar and the "risk aversion" wave, gold ended May only 0.5% lower, but other commodities were not that lucky. Oil ended down 14.6%, platinum 10.5%, copper 5.9% and palladium 14.7% although the latter had risen 91.0% in the preceding nine months.

Photonomics 1: Georges Braque. *Olive tree near Estaque*. 1906. Oil on canvas. 50 x 61cm.

Global equity markets have begun June on the back foot, having been plagued by the same factors that influenced them during May. The Table below provides a snapshot of selected markets, based on MSCI indices, as at 2 June. The MTD and YTD columns refer to month and year-to-date returns respectively and the final column on the right, entitled "% Dev 200mda" depicts the extent of deviation below their 200-day moving average, in percentage terms. It shows how far below its long-term (200-day) average a market is trading at. The Table makes for sobering reading.

Table 1: MSCI performances to 2 June 2010

		Price performance			
	Market cap, $bn	MTD	YTD	2009	% Dev 200dma*
ACWI	23,246	-0.3	-7.7	31.5	-6.6
Developed	20,283	-0.1	-7.6	27.0	-6.7
US	10,348	0.8	-1.6	24.2	-1.1
Canada	1,074	0.6	0.0	52.7	0.8
Europe	5,642	-0.4	-18.0	31.2	-17.0
UK	1,900	-0.5	-14.3	37.3	-12.2
Japan	2,049	-2.6	-4.1	4.4	-7.3
Australia	723	-1.8	-16.6	68.8	-16.2
Hong Kong	218	-1.2	-9.0	55.2	-7.7
Emerging	2,962	-1.9	-8.2	74.5	-5.4
China	550	-2.8	-11.0	58.8	-8.3
Korea	394	-1.9	-7.8	69.4	-6.1
Taiwan	319	-3.6	-14.2	75.1	-9.0
India	234	-2.9	-4.8	100.5	-2.3
Russia	197	0.2	-7.0	100.3	-6.5
Brazil	472	-1.5	-13.8	121.3	-9.2

Source: Merrill Lynch

You will note from the Table that the recent market weakness has pushed global equity markets, with the exception of Canada, into the red. The European MSCI index is already down 18.0% this year so far, Australia, a noted commodity-driven economy, is down 16.6%, Brazil

13.8% and the UK 14.3%. If one incorporates the next two days of June, not shown on the Table, all markets are down for the month-to-date as well. It is interesting to compare the year-to-date performances with those of 2009. In a very short space of time, say from mid-April, sentiment in global investment markets has taken a drastic turn for the worse.

What's on our radar screen?

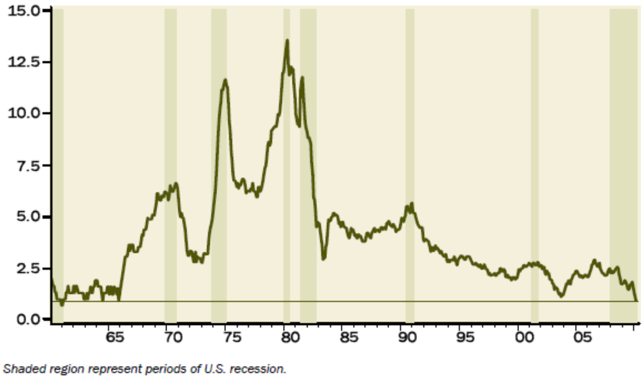
Here are a couple of items we are keeping a close eye on:

- *The SA economy:* March retail sales rose 0.4% month-on-month, bringing the annual change to 1.0%, the first positive number in four months. Manufacturing production in March rose 6.3% on an annual basis, which was higher than expected and confirmed the subsequent first quarter (Q1) GDP growth, which at 4.6% (quarter-on-quarter, annualised) was much better than expected. Growth in the December quarter (Q4 09) was 3.2%. The growth came from external demand and the replenishment in inventories rather than from rising domestic demand, which remains relatively flat – it only grew at 2.7%. The relatively weak state of domestic demand underscores our view that inflation is likely to remain muted for some time and does not pose an immediate threat to the SA economy. Speaking of which, the April inflation rate of 4.8% was below expectations, which confirms our view on inflation and the possible future direction of SA interest rates. At their recent meeting the Reserve Bank kept interest rates on hold although we still think there is a reasonable chance that rates will be cut by 0.5% at the July 22 meeting. The Bank sees inflation bottoming at 4.7% in the third quarter and is forecasting economic growth of 2.7% in 2010 and 3.6% in 2011. During the first quarter of 2010 unemployment in SA rose to 25.2% from 24.3% in Q4 09. In the broadest terms, when those who have given up looking for work are included, the unemployment rate rises to 35.4% (34.2%); more than a third of the country is effectively unemployed. That compares to a rate of around 17.1% in the US.
- *The Indian economy*: we watch India closely because it is so large and influential in today's global economy. Similar to China and unlike any of its Western counterparts, the Indian economy is still growing rapidly, having weathered the Global Credit Crisis relatively well. The Indian economy grew by 8.6% during the March quarter; the economy grew for the year to end-March by 7.4%. India's government has forecast a growth rate of 8.5% for 2010 as a whole.
- *The Chinese economy*: we often speak of the China phenomenon in glowing terms, which may hide the fact that we believe China will go through the same growing pains as any other developing country and will eventually, albeit probably not in our generation, become "just another country" with problems like any other. During the past few weeks we heard of two incidents which underlined this view. Against the backdrop of China being the lowest-cost producer in the world by far, wages have started to rise at levels above the prevailing inflation rate. Striking workers (striking workers in China? Yes, that's correct) at a Honda plant in Guangdong settled for a 24% wage increase (to $280 per month) after having initially demanded a 50% increase. In addition Foxconn raised wages 30%. This electronics manufacturing company has attracted attention recently for all the wrong reasons; nine workers recently committed suicide at the plant, where 400 000 workers are employed. There is a long way to go, but there is no reason to believe that Chinese manufacturers will not eventually also succumb to "normal" factors like wage (and other) pressures.

Photonomics 2: Pablo Picasso. *The Pigeon with Peas*. 1911-1912. Oil on canvas. 64 x 53cm.

- *The US economy*: annual headline inflation for March is running at 2.2%, having declined 0.1% on the actual month. March core inflation i.e. excluding food and energy prices, is now only 0.9%, its slowest pace since 1961. We remind you that one of Maestro's "Big Picture themes" is "US deflation before inflation". We continue to believe that the risk of deflation in the US is greater than inflation, and that it represents far more of the risk to the integrity of the economy and is more difficult to manage and expunge than inflation – refer to Chart 2 for the long-term trend in US core inflation.

Chart 2: US core inflation – at lowest level since 1961



Source: Gluskin Sheff

Charts of the month

Following on from last month's comments, where we noted Maestro's conservatism as a reason for our recent under-performance Chart 3 depicts this aspect of the investment market very nicely. Investments that are of a poorer quality tend to outperform during a bull market, or at least a bear-market recovery. The reasons for this are simple: poorer quality companies, many of which are saddled with more debt, have greater operational and financial leverage to a recovery. They were often also sold down more heavily in the market downturn, so it is logical that they may and do rise dramatically during an upturn.

Photonomics 3: Henri Matisse. *La Pastorale*. 1905. Oil on canvas. 46 x 55cm.

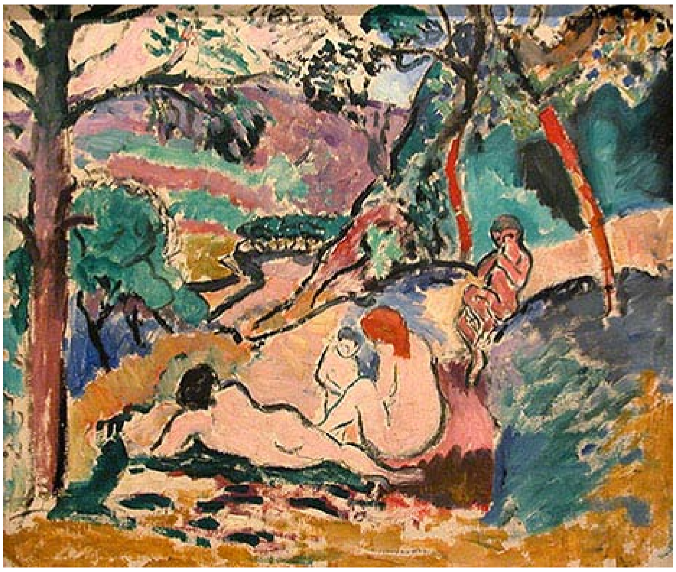
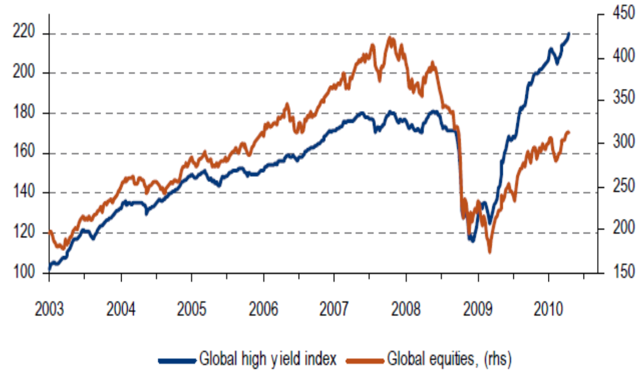


Chart 3 shows a high yield (read "junk bond") index versus the global equity market. The equity market fell from a greater height but high yield (junk) bonds have rebounded more, to the extent that they are currently at a new high, whereas the equity market is still some way off its 2007 peak. As we say internally "even turkeys fly in a hurricane". Of course, what the chart does not show is that the risk implicit in lower quality assets is frequently far greater, which is one of the reasons why Maestro focuses on high quality investments. The price we pay for this decision though is temporary underperformance – which is what we suffered last year when markets rocketed off their March trough. In the long-term though, we retain our belief that high-quality investments will perform better; this is borne out by our long-term returns. In addition, most private clients feel more comfortable knowing that their portfolios are invested in less volatile assets which have less risk.

Chart 3: When quality doesn't count ...

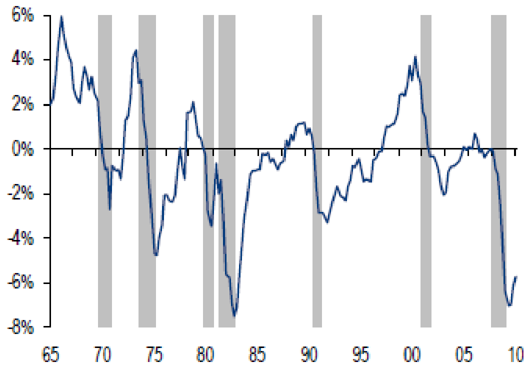


Source: Merrill Lynch

There are a couple of charts I'd like to share, so forgive me if I discuss more than one. We passed a few comments on US inflation above, and depicted an historic perspective of US inflation in Chart 2. Here is another chart on the topic, which further serves as reason for our view that inflation in the US does not pose an immediate threat.

Chart 4: The US output gap as a % of potential GDP

Shaded areas represent periods of recession



Source: Merrill Lynch

Chart 4 shows the historic output gap in the US as a function of GDP. Without going into too much detail, the output gap shows the difference between the *actual* level of production and the *potential* level, in other words the extent of spare capacity or "slack" in the economy. From this chart you can see how much damage has been inflicted on the US by the recent Global Credit Crisis. It shows that there is plenty of slack in the US economy. Prices are therefore unlikely to increase in the near term i.e. inflation is not an immediate threat. Remember that typically firms only gain pricing power once they are operating at or near full capacity and there is a scarcity of resources – hardly a description of the current conditions. Applying some numbers to the output gap and using the Fed's projections of 3.5% and 4.0% growth for the US economy in 2010 and 2011 respectively, the output gap would be "filled" or closed only in the first quarter of 2013. But this exercise is very sensitive to growth. For example, if a growth rate for 2010 and 2011 of only 3.0% is used, then the output gap will only close in mid-2018. Simply put, inflation is not a problem in the US for the foreseeable future, which implies that the Fed is likely to keep interest rates very low for a very long time still. Which, by the way, means that as long as the rates in South Africa remain relatively high, *all other things being equal*, the rand is likely to remain attractive to global investors and is likely to remain relatively firm.

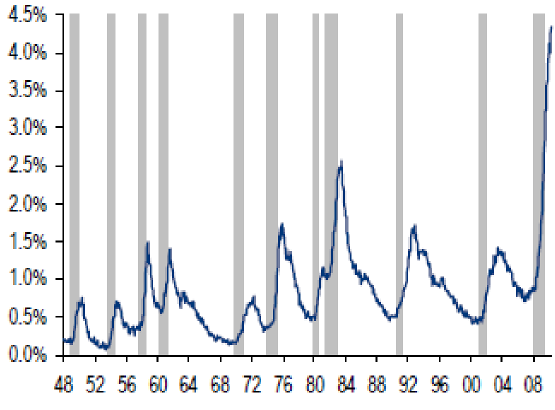
Photonomics 4: Fernand Léger. *Still Life with Chandelier*. 1922. Oil on canvas. 116 x 80cm.

Talking of damage to the US economy during the recent Credit Crisis, Chart 5 places this into more perspective. Unemployment is a huge problem around the developed world at present. Europe, for example, recently released data that showed the Eurozone unemployment is now 10.1%. In the US it is 9.7%, despite the number of jobs having increased in recent months. This may sound like a contradiction – jobs increasing by unemployment rising simultaneously – but it is not. The reason for this is that people who have long since given up looking for work i.e. those who left the unemployment pool, are now looking for work again i.e. they are re-entering the labour pool. The number of unemployed or looking for jobs thus increases.

Chart 5 shows the history of the number of long-term unemployed people in the US –look how the number has risen since late 2007 i.e. when the Global Crisis began. This is a good example of the structural damage that has been done to the economy. Although the chart reflects the US situation you can rest assured the story in the Eurozone, the UK and in most of the developed world looks very similar. The subject of unemployment has the added disadvantage of being very sensitive politically, which increases its relevance in the formulation of economic policies.

Chart 5: US long-term unemployment (% of labour force)

Shaded areas represent periods of recession



Source: Merrill Lynch

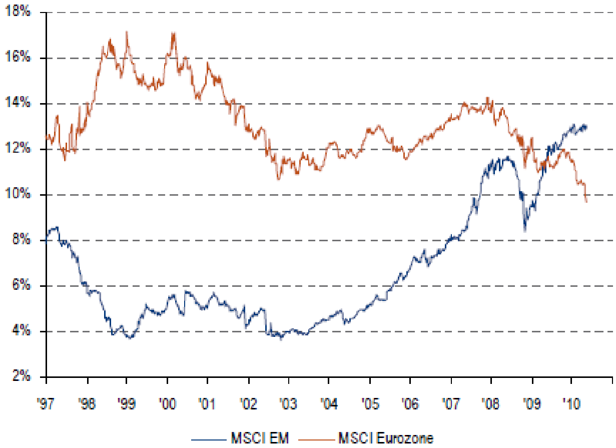
The next chart shows the price of the euro in dollar terms. We included this chart in our March quarterly report, but it has changed so much we need to update you again. The euro's rate of depreciation, for reasons that are well know and revolve largely around sovereign risk and the questions about the European economy, has increased dramatically since mid-April. It has surpassed the low point reached in late 2008 and March 2009 during the "flight to quality" in the midst of the Global Credit Crisis and is currently trading at a four-year low. To place that in perspective its all-time low during its 11-year existence was 83c to the dollar, which it reached in October 2000, and which is some 30.6% below its current level of 1.1967c.

Chart 6: The euro - is parity looming and if so, when?

Source: Saxo Bank

Another chart that we found very interesting is shown in Chart 7. A couple of years ago we spent quite a bit of time in *Intermezzo* and our other publications listing the reasons why we thought emerging markets would “de-couple” from developed ones; why we thought they represented a better investment opportunity in the future. When emerging markets collapsed more than developed ones during the Credit Crisis the “de-coupling theory” was trashed in the mainstream media and our views were seen as being off-target. It is interesting to see that the de-coupling debate has even disappeared off the radar screens of the mainstream media. But we have not forgotten about it; emerging markets remain an important theme of ours. This may not seem relevant to local investors, but can I remind you that South Africa is an important emerging market. Our attitude towards the SA equity market is informed to a large extent by our views towards emerging markets in a global context.

Chart 7: Emerging versus Eurozone market cap
As % of world market cap



Of course, this is a huge debate and one we could not cover adequately here But Chart 7 provides more proof of the rising importance of emerging markets. It shows that market capitalization of emerging markets i.e. the total value of all shares traded on global emerging markets, has now exceeded the market cap of the entire Eurozone. This in itself is less important than the trend over time. The trend and momentum of the two regions since 2003 is very clear.

Photonomics 5: Amedeo Modigliani. *Lady with fan*. 1919. Oil on canvas. 100 x 65cm.

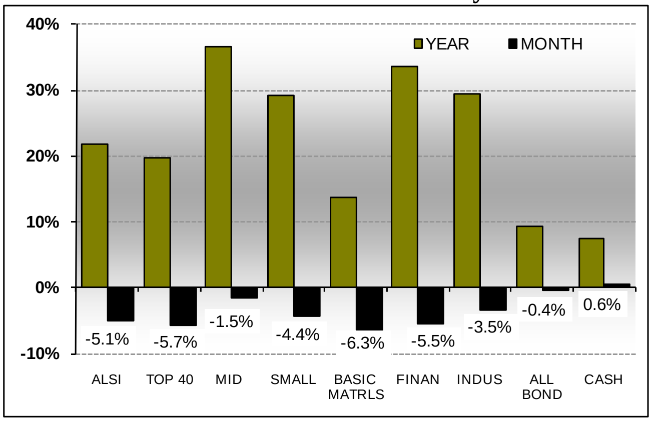
A few quotes to chew on

When asked what it was like to be hunted by the “electronic bond herd” for the past six months Greek Prime Minister George Papandreou had the following to say: *“Because of the 2008 crisis, all the market players have become much more risk-averse, so they are on a hair trigger. Today’s market players are like an animal that has been wounded, and so it recoils at the lightest motion. So any rumour about you can become a self-fulfilling prophecy. Comparing bond players to some kind of living beast may be unfair to beasts. These markets are not even human anymore. Some of these* *things are computerized, and they just go into automatic mode when they see a hint of trouble”.*

Speak of which, a Greek friend of mine recently sent me the following, actually an ancient Greek text: “*Our democracy is destroying itself because we have abused our right of freedom and equality, because we have taught our citizens to consider impudence as a right, lawlessness as freedom, rudeness as equality, and anarchy as supreme happiness.* Isocrates, 2 500 years ago i.e. Athens in the 5th century BC.

The crisis in recent weeks and the ensuing policy panic cannot be ignored. In response, policymakers in Europe stepped up and have announced a massive support plan for the periphery. In so doing, they have reaffirmed that the regime of low interest rates and high global liquidity abundance remains in place. But events in Europe also signal the onset of a fiscal retrenchment across the developed world in the form of lower spending, higher taxation and deeper regulation. Monetary policy argues for further upside in risk assets. Fiscal policy argues for constrained upside in risk assets. Michael Hartnett, Chief global equity strategist, Merrill Lynch

Chart 8: Local market returns to 31 May 2010



May in perspective – local markets

Given what happened on global markets in May the SA equity market was never going to be pretty. Despite a 4.3% slide in the rand (it had been down as much as 8.7% at one stage) the basic material index ended down 6.4%. Financials ended 5.5% lower and industrials 3.5%. The mid and small cap indices held up rather well, ending down 1.5% and 4.4% respectively. The general finance (-9.1%), general mining (-9.0%) and beverages (-8.7%) were the weakest sectors during the month. The gold index rose 6.7%. Unlike the global bond market the SA bond market ended down by 0.4%, bringing its annual return to 9.4%, not much more than cash’s annual return of 7.5%.

The Final countdown

At the time of publishing this *Intermezzo* there are just 4 days to go before the kick-off in the 2010 FIFA World Cup Final. I include a few pictures of the Cape Town stadium this month, particularly for the benefit of our overseas readers. In the June 2007 edition of *Intermezzo* we included this photo of the stadium, as work had just begun - note the old stadium on the left that was demolished to make way for the new one.

Photonomics 6: Green Point stadium, Cape Town

Work continued like crazy and it looked like this about two years later.

And now it looks like this (see overleaf), signed, sealed and delivered. Another picture taken at night can be found at the end of this edition. A number of matches have already been played at the stadium as the organizers have tested the facility and trained its staff. Now it is fully ready and South African stands ready to welcome the visitors to our shores.

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Source: Google Earth

For those who are unable to make it South Africa, you need to know that there is a palpable level of excitement in the country. Cape Town has been slow to "catch the fever" but it has been raging in places like Johannesburg for some time already. Cars are adorned with flags, some of them with two or more flags flying; side mirrors are bedecked with glove-like covers in national colours. Flags of participating nations fly wherever you look and adorn every shop and shopping mall. And there is the odd wonderful, "way-over-the-top" expression of excitement, such as this giant vuvuzela that has been erected in Cape Town near the stadium – see below. The vuvuzela, sponsored by Hyundai, will go down in the Guinness Book of Records as the largest ever, measuring a cool 35m long and 5.5m in diameter. Only in South Africa!

Photonomics 7: Viva Cape Town Vuvuzela!!

Source: www.zoopy.com

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. Returns include income and are presented after fees have been charged.

Table 2: Returns of funds under Maestro's care

	Period ended	Month	Year to date	Year
Maestro Equity Fund	May	**-4.5%**	**-1.3%**	**14.7%**
Maestro equity benchmark *	May	-5.3%	-0.6%	24.5%
JSE All Share Index	May	-5.1%	-0.9%	21.9%
Maestro Long Short Equity Fund	Apr	**0.6%**	**2.8%**	**24.5%**
JSE All Share Index	Apr	-0.1%	5.0%	41.8%
JSE Financial and Indus 30 index	Apr	0.8%	6.6%	44.7%
Central Park Global Balanced Fund ($)	Apr	**-1.5%**	**-2.4%**	**9.6%**
Benchmark**	Apr	0.4%	2.4%	19.0%
Sector average ***	Apr	0.7%	1.2%	23.7%

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 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 ($)

File 13: Information almost worth remembering

Okay, with all the negative news about the markets and the global change in sentiment, you are probably about to rush out and slit your wrists! But don't! It isn't all bad news. Let's lighten up and move on to this month's File 13, which, for the benefit of our new readers, is there to touch on interesting or amusing topics that are *almost* worth remembering.

Seeing that we are so close to the World Cup Final, for a laugh let's start off with proof that geography should be compulsory for all news producers – see the picture below. (*Ed*: why am I not surprised that the TV station is a US (Chicago-based) one?

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A few years ago we drew your attention to the Nano, a car that was to be produced by Tata Motors of India and which would become the cheapest car in the world, selling for one lakh, roughly the equivalent of $2 500 or R18 750. Here is some news on how things are progressing with the Nano's rollout: the initial sales period for the first Nanos in April last year attracted orders for 206 703 cars. Tata chose the first 100 000 customers for the 624cc car by lottery. The car has one windscreen wiper, no radio and no air conditioner. Deliveries began in July. During the past week Tata opened their second factory at Sanand, having abandoned a partly completed (second) factory in October 2008 in Singur, West Bengal, after the local community demanded the return of the land on which the factory was being built. The new factory will have the capacity to manufacture 250 000 cars per annum. The demand for cars in India is estimated to reach 3 million by 2015, of which 1 million will be low-cost cars. Nissan, Renault and Bajaj Auto are jointly developing a $3 000 car for 2012 in an effort to attack the market share of India's two largest car makers, Suzuki India and Hyundai Motors India. Most executives of Western car manufacturers can only dream of this kind of market for their product.

Photonomics 8: Cape Town World Cup stadium at night

In last month's *Intermezzo* we drew your attention to the world record for the highest price ever paid for an art work. The art market is indeed robust and prices are very firm. Certain works are in great demand; so much so that on 19 May a lone thief broke into the Museum of Modern Art in Paris and stole five works with an estimated $120m (some have suggested the works are worth far more than that). The artists whose works were stolen were Georges Braque, Fernand Léger, Henri Matisse, Amedeo Modigliani and Pablo Picasso. The art works that appear throughout this edition of *Intermezzo* are the works that were stolen. If you happen to see any of them or if they get offered to you surreptitiously, please do let me know. All the pictures of the works were obtained from www.guardian.co.uk.

Table 3: MSCI returns to 31 May 2010 (%)

	May'10	YTD	QTD
Peru	2.4	2.8	2.7
Colombia	-1.7	8.4	-1.5
Chile	-2.2	0.5	0.5
Thailand	-2.9	5.1	-6.7
Philippines	-4.9	3.2	-0.4
China	-6.5	-8.5	-7.0
Mexico	-6.6	0.5	-6.7
Malaysia	-7.1	4.8	-3.2
Hong Kong	-7.1	-7.9	-9.8
South Africa	-7.4	-3.0	-6.8
Indonesia	-7.7	7.7	-2.1
Japan	-8.1	-1.6	-8.3
India	-8.2	-2.0	-6.5
LatAm	**-8.9**	**-8.5**	**-9.7**
MSCI EM	**-9.2**	**-6.4**	**-8.3**
Singapore	-9.5	-6.2	-4.9
Taiwan	-9.8	-11.1	-7.5
Morocco	-9.9	0.7	-5.6
MSCI DM	**-9.9**	**-7.6**	**-10.1**
EMEA	**-10.3**	**-5.3**	**-10.6**
Brazil	-10.9	-12.5	-12.1
Argentina	-10.9	-7.2	-11.8
AP ex Japan	**-11.1**	**-8.7**	**-10.1**
Israel	-11.2	-9.9	-17.9
Czech	-12.1	-12.1	-11.9
Russia	-12.3	-7.1	-13.0
Turkey	-12.5	-3.3	-6.8
Pakistan	-13.0	-5.3	-11.9
Egypt	-13.2	4.1	-5.9
Korea	-13.4	-5.9	-8.5
Poland	-15.0	-11.9	-15.5
Australia	-17.1	-15.1	-17.5
Hungary	-22.5	-13.2	-22.9

Source Merrill Lynch