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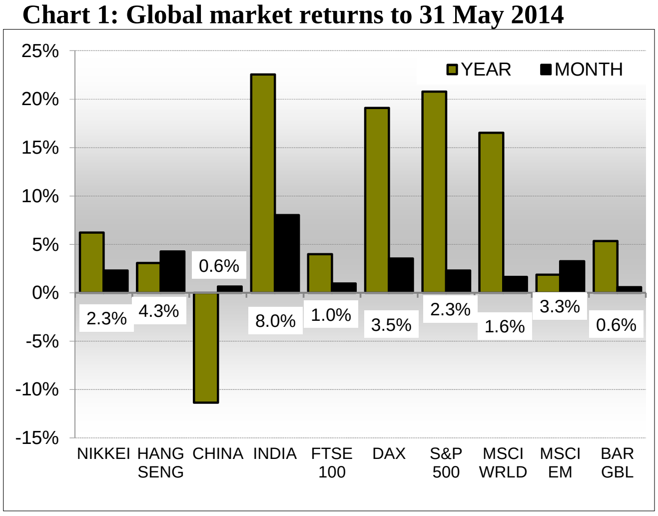
Investment Letter | 14th Edition | June 2014

May in perspective – global markets

May proved to be another interesting month on global equity markets, with many closing close to or at all-time record levels. Despite the new records, equity markets are actually moving very slowly – "grinding higher" would be an apt description – partly on the back of unexciting economic data from the major regions (after all the US economy declined 1.0% in the first quarter) and an increasing lack of visibility of the global economy. Markets have also moved away from levels which once represented deep value, so investors are entering markets at current levels with some trepidation. That said, given the ongoing efforts on the part of global central bankers to continue to supress interest rates at artificially low levels, and the very high (price) levels that bond markets are trading at – see the section below on bond market developments – the seems little option but to commit assets to equity markets, all of which has helped them grind slowly higher. The MSCI World index rose 1.6% while the Emerging market index rose 3.3%. While the latter may look appealing, one would do well to note that the juicy emerging market returns are ascribable to only two markets: India, which rose 8.0% on the back of their favourable (at least for business) election outcome and Russia, which rose 14.0%. Despite the strong monthly return from Russia, it is still down 8.9% for the year-to-date. India is up 14.4% over the same period and Indonesia 14.5%. China, on the other hand, is down 3.6% for the year-to-date; it rose only 0.6% in May. So as you can see, various regions are delivering mixed performances, often for regionally-specific reasons.

Chart 1: Global market returns to 31 May 2014



As we noted above, bond markets enjoyed another positive month. The Barcap Global Aggregated bond index rose 0.6%, bringing its year-to-date return to 4.2%, higher than both the US equity market and MSCI World index returns. Apart from a few bright spots commodities performed poorly during the month; the CRB commodity index, a proxy for global commodities, fell 1.5% in May. The real weakness was seen in soft commodities, as good US weather conditions saw the price of wheat, corn and cotton fall 12.0%, 9.4% and 8.4% respectively. The performance in the precious metals space was mixed; the gold price fell 3.0% although platinum and palladium rose 2.8% and 4.1% respectively. Base metals were relatively strong; copper rose 2.9% and nickel 5.6%, while bulk metals were led lower by a 15.2% decline in the iron ore price.

Table 1: SA economy growth – details of Q1 growth

	2013	2013		2014
	ann. ave	Q3	Q4	Q1
Agriculture	2.3	3.6	6.4	2.5
Mining	3.1	11.4	15.7	-24.7
Manufacturing	0.8	-6.6	12.3	-4.4
Electricity	-0.4	3.8	-5.6	0.1
Construction	2.8	2.1	3.1	4.9
Trade	2.2	1.3	2.3	2.1
Transport & comms	1.9	2.6	1.6	1.7
Finance & business	2.4	1.3	1.5	2.0
Government	1.5	0.4	0.9	1.7
Personal services	1.8	1.6	1.3	1.0
GDP at basic prices	*1.9*	*0.6*	*4.1*	*-0.9*
Taxes less subsidies	2.1	2.1	1.8	1.3
Total GDP	**1.9**	**0.7**	**3.8**	**-0.6**

Source: Deutsche Bank

What's on our radar screen?

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

- *The SA economy:* the annual inflation rate rose to 6.1% in April from March's 6.0%, in so doing breaching the official range of the SA Reserve Bank (SARB) for inflation of between 3% and 6%. The core inflation rate remained unchanged at 5.5%. The main driver of inflation in April was food prices, which rose 8.2% year-on-year, up from March's 7.2%. Notwithstanding the higher inflation SARB left interest rates unchanged at its April meeting but warned that rates would rise in due course and that the "tightening cycle" has begun. It also revised down its 2014 growth forecast for the SA economy from 2.6% to 2.1%. Speaking of growth, after having grown at 3.8% during the last quarter of 2013 the economic growth rate slumped to -0.6% in the first quarter of 2014 (Q1). Not surprisingly the largest drag on the economy came from the mining sector, which declined 24.7%. The manufacturing sector contracted by 4.4% as can be seen from the Table 1, which sheds more light and analysis of the latest growth data. We would not be surprized if the SA economy is already be in a recession technically, although hopefully it will not last too long.

- *The US economy:* Data emanating out of the US was generally mixed with a stronger tone. However, the initial estimate of Q1 growth of 0.1%, which in itself was a bit of a surprize but perhaps weather-related, was later revised down to a level of -1.0%, the first decline since the first quarter of 2011. Most of the decline was explained by adjustments to inventories, which provides some hope that as inventories are replenished in the second quarter and beyond, growth in the US economy will resume. The equity and bond markets took the setback in their stride, rising to record levels on the day!
- *Developed market economies*: The most significant news of the month in economies other than the US was the cut by European Central Bank (ECB) Governor Mario Draghi of interest rates to levels below zero. This action was brought about as the eurozone desperately fights off deflation; eurozone inflation in May was only 0.5% and the ECB lowered its 2016 inflation forecast to only 1.5%. Growth in many EU countries is all but absent; desperate times call for desperate measures. In an effort to stimulate bank lending (yet again!) the ECB unveiled a package that included €400bn of cheap loans, with the promise that if it didn't work, there was more to come.
- *Emerging market economies:* **Chinese** inflation rose 1.8% in April from 2.4% in March and retail sales increased at an annual rate of 13.2%. The **Indian** economy grew 4.6% in the year to March although inflation remains stubbornly high at 8.6%. Compare this to **Brazil's** growth of only 1.9% (quarter-on-quarter growth in Q1 was only 0.2%). Retail sales decreased by 0.1% in the year to March and industrial production declined 0.9%. In **Turkey**, where the unemployment stands at 10.2% and inflation at 9.4%, the central bank announced a surprise interest rate cut. It reduced its one-week repo rate from 10.0% to 9.5%.

What is happening in the global bond market?

We don't often comment on detailed developments in the price and yield i.e. interest rate movements in global bond markets. However, we need to bring to your attention the latest developments in global bond markets, which for many investors including ourselves, are of increasing concern. Many of us are scratching our heads about what the implications of the latest price movements are.

Photonomics 1: A wolf lurking in Dinali Park, Alaska

Before we start, remember there is an inverse relationship between bond prices and yields (i.e. the level of interest rate at which the bonds trade). When yields (interest rates on bonds) move lower, their prices move higher. With that by way of introduction, let's consider what has been happening in global bond markets of late.

In short, bond prices have been rising to record (high) levels and yields (interest rates) have been declining to record (low) levels. Typically, yields rise and prices decline when an increase in the underlying economic activity is expected. So not surprisingly, with most market participants expecting increasing economic activity across the world, and in the eurozone and the US in particular, the consensus expectation at the beginning of this year was for bond yields, which were already at very low levels (prices were high), to start rising. Investors had positioned themselves accordingly, which seemed a rather obvious stance to adopt. Global bond markets were expected to deliver poor performance; bond prices would decline from their record high levels. Most investors were expecting negative returns from bonds.

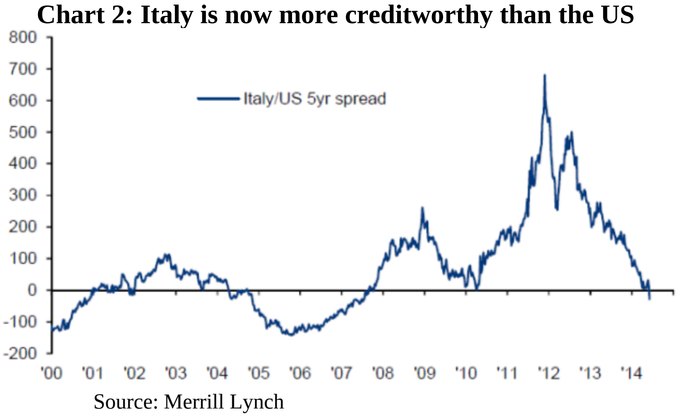
However, one of the surprizing developments this year has been the ongoing strength in the bond markets i.e. prices have continued to rise and yields have continued to decline. Not only that; some of the yields that were least likely to decline further, such as those of peripheral European countries (remember the PIIGS, being Portugal, Italy, Ireland, Greece and Spain) have in actual fact declined the most.

Now, we are not that surprized that the initial (and our) view is proving to be incorrect; seasoned investors and investment managers in particular should be reconciled to the fact that they will not always "get it right"! What is of greater intrigue to us is "what does all of this mean?" What are the consequences of declining rates (yields); how low are they going to go and why do investors continue to buy an asset from which there will surely be very little return and a good chance of a negative return – for many years, not just the immediate future?

Let me give you some examples of recent developments in global bond markets and show you what yields have been doing of late:

- Dutch yields are now close to 500-year lows
- Spanish yields are (at the time of writing) at all-time lows, despite (or perhaps because of) the catastrophic state of the Spanish economy.
- Italian bond yields are close to 70-year lows.
- German bond yields are only just above their all-time lows.
- The difference between US and German 10-year yields is currently 110 basis points (1.10%), versus the 3-year average of 47 basis points.
- Only last week the Italian 5-year yield declined to a level lower than the US 5-year bond, which simply means that investors believe Italy represents a lower risk that the US; you can formulate your own view on that score but you will have to agree that these kind of movements hardly make sense. Less than three years ago Italian 5-year bond yields were trading 7.0% (or 700 basis points or bps in industry jargon) higher than comparable US yields. At the time of writing they were trading 25bps (0.25%) lower than US bonds, as seen in Chart 2. This is not an isolated case; Spanish yields are now also lower than those in the US, as depicted in Chart 3.

Chart 2: Italy is now more creditworthy than the US



Source: Merrill Lynch

Deutsche Bank Economic historian, Jim Reid, summarized the current situation nicely, after the ECB Governor Draghi cut interest rates to virtually nil and effectively lowered rates for bank into negative territory i.e. it will now cost banks to retain their money and deposits at the ECB.

Chart 3: Spain yields are now also lower than US yields

Source: Merrill Lynch

Jim Reid wrote as follows: "These are truly remarkable times. As we said when we published 'A Journey into the Unknown', the uniqueness of this situation with yields generally close to multi-century all-time lows proves how uncertain the outlook remains. There really is no precedent for so many countries to have such low yields. None of us can know the full ramifications of this. In simple terms there are two ways to look at this. Either bonds are the short trade of the millennium (literally) at these levels or that something very unusual is going on globally and will continue for some time. Our view remains slanted towards the latter although at these levels it really is hard to recommend being long if making a decent return is your aim. We think yields (will) stay low for longer but that we might be near the bottom of the range at the moment… It's fair to say the package of moves (presented by Draghi) will be debated for some time yet. …Our first reaction is that the move is likely to steadily increase the wedge between financial asset performance and economic fundamentals and prolong the existence of this theme. It's nearly 7 years since the ECB first intervened aggressively to try to free up bank markets. Would anyone have guessed the combination of events that has occurred since? i.e. extreme global unconventional policy still continuing to this day, 5 years plus of zero interest rates, rampant financial markets, multi-century all-time lows in yields and the weakest economic recovery on record bar the Depression. Everybody would have had a chance of getting some of this narrative correct but I doubt anybody would have predicted the combination. It's a unique cycle and as such its one where uncertainty/visibility is high even if volatility is low thanks to central bankers. It's amusing to hear central bankers warn about complacency in markets which if present is largely due to the impact of their policies.

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Photonomics 2: A tiger lurking in India

… Overall I think the measures are more market friendly than economic friendly though. Monetary policy works with long lags and even if these measures were to stimulate activity/inflation (which is still debatable) we might not see it in the data until well into 2015. The clamour for more stimulus is likely to emerge well before that. However Draghi has likely bought himself some time at least."

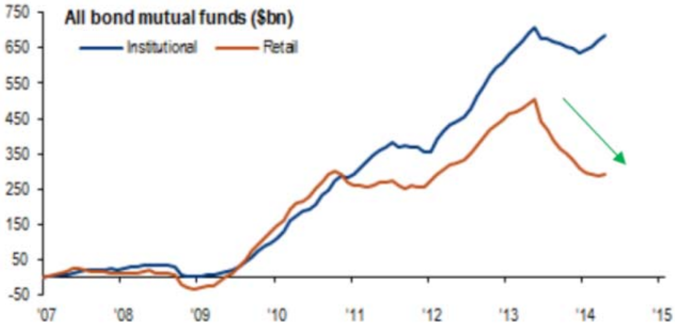
I think you get the picture: bond rates at their current multi-year lows represent something of a conundrum and run counter to the message being sent out by the record levels of global stock markets. Time will tell how this paradox will eventually resolve but for what it's worth, we don't believe that a collapse in share markets is imminent and to be honest it is hard to see what the catalyst will be for bond rates to move higher (prices lower). So for now, it is best to assume we are in for "more of the same" but we are not being complacent about it. We are watching the markets very closely for any signs of disquiet.

Charts of the month

Having spent a bit of time, above, on the latest and intriguing developments in global bond markets the following charts are even more interesting. But just before we show the charts, remember that all the evidence points to the fact that global investors are still sitting on large cash piles i.e. many if not most of them are missing out on the rally in global equities. In addition, many have not yet begun in earnest to switch from the bond to the equity market. This is one of the main reasons we hold the view that the equity markets are well supported, even at their current elevated levels. To reiterate a theme we have held for a long time now, the Great rotation (out of bonds and into equities) has hardly begun.

Chart 4 depicts the strong buying into the bond market, particularly on the part of US institutions. Note that the buying really picked up after the onset of the Great Financial crisis in 2007, which was the appropriate investment stance to have taken, given that interest rates started declining sharply (prices started rising) from that time onwards. It is interest to see from Chart 4 though that retail investors have already started buying fewer bonds though.

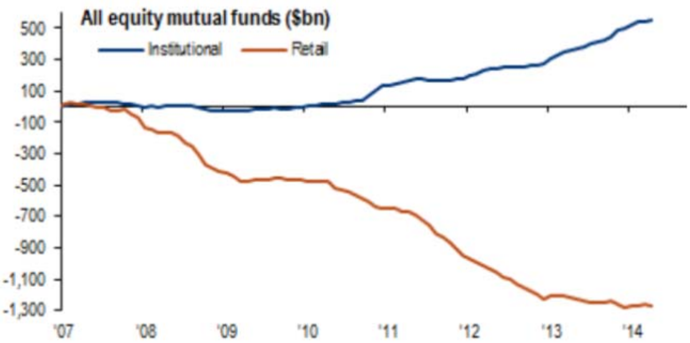
Chart 4: Retail investors are investing less into US bond unit trusts



Source: Merrill Lynch

Chart 5 on the other hand shows that while institutional investors have by and large been buyers into US equity unit trusts, US retail investors have been withdrawing trillions of dollars – literally – from the US equity market since 2007, an investment stance that has been 100% incorrect and which has collectively cost them trillions of dollars in opportunity costs. One can only think what retail investors must be thinking as they watch global equity markets reach new records nearly daily! I should add here that US retail investors have a consistent history of getting their investment view 100% wrong – they are what we in the industry refer to as "the perfect contra-indicator".

Chart 5: Institutional and retail activity in US equity unit trusts



Source: Merrill Lynch

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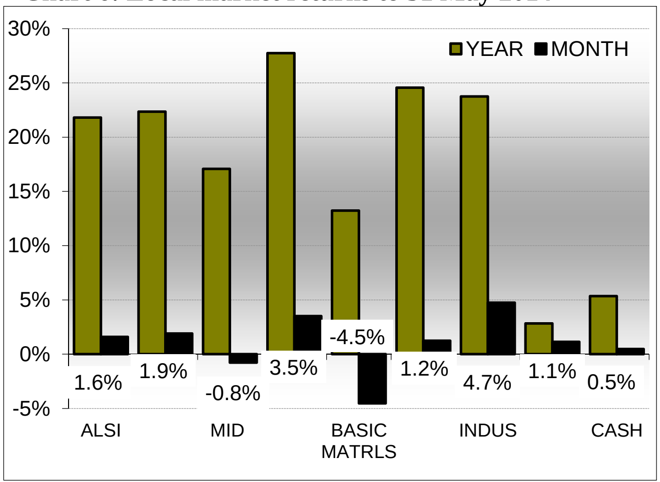
May in perspective – local investment markets

Local equity markets saw a reversal of behaviour relative to what we have experienced during the past few months. Instead of being led by basic material shares, the local equity market saw the industrial index leading the charge. It gained 4.7%, bringing its year-to-date return to 7.2%, while the basic material index declined 4.5% in May, bringing its year-to-date return to 7.6%. The financial index rose 1.2%; on a year-to-date basis the index is up the most, some 11.7%, fuelled in part by a stronger rand in recent months. The latter declined 0.5% against the dollar and has now lost "only" 5.0% against the greenback during the past year. Back to equities, small caps enjoyed a robust month, rising 3.5%, large caps rose 1.9% while mid caps declined 0.8%. On a year-to-date basis small caps have risen the most, up 11.1%, followed by large caps up 9.1% and mid caps 6.1%. No matter which way you look at it, this year is proving to be another profitable one on the SA equity market.

Chart 6: Local market returns to 31 May 2014



The best performing sectors during May were the media sector, which rose 17.6% (Naspers rose by a similar amount), support services rose 10.4% and forestry and paper 8.8%. The gold sector, having risen by 53.0% in the four months to April, declined 12.8%. The industrial metals sector declined 11.3% and tech hardware and equipment 10.7% (Pinnacle fell a like amount). The SA bond market followed the global trend, rising 1.1% to bring its year-to-date return to 2.4%.

A few quotes to chew on

Most market commentary at this time continues to be around the prevailing abnormal market conditions, despite the fact that we are now five years into them; they are starting to feel decidedly "normal". Speaking about the disruptive influence that central bankers have been in recent years, *Merrill Lynch economist Ethan Harris* reminded us in particular of the inflationary disruption that central bankers actions continue to have on the market.

He writes "And the inflation disruption continues and remains meaningful:

- The "price" on money is zero: 56% of the world economy is currently under the spell of zero rate policies
- The "value" of assets is inflated: central bank liquidity rose $1.3trn in 2013 and is set to rise another $1.8trn in 2014 via increased asset purchases and forex reserves
- The "supply" of bonds is reduced; the Fed own 19% of outstanding Treasuries (US bonds) and has purchased about 90% of all 5- and 10-year bonds issued since 2011.
- And finally the supply of equity is also reduced as global corporations recycle profits and cash back into financial markets rather than the real economy. Stock buybacks and cash Mergers and Acquisitions (M&A) has reduced the float of the US equity market by an enormous $1.65trn since 2009; we forecast the US equity market is set to decline by another $565bn in 2014".

For the record

Table 2 below lists the latest returns of the mutual and retirement funds under Maestro's care. You can find more detail on our website at www.maestroinvestment.co.za. Returns include income and are presented *after* fees have been charged. Fund Summaries for each respective fund listed in the table are available on our website.

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

	Period ended	Month	Year to date	Year
Maestro Equity Prescient Fund	**May**	**3.0%**	**4.2%**	**23.7%**
JSE All Share Index	*May*	*1.6%*	*8.8%*	*21.8%*
Retirement Funds				
Maestro Growth Fund	**May**	**2.3%**	**3.5%**	**17.3%**
Fund Benchmark	*May*	*1.4%*	*6.3%*	*15.5%*
Maestro Balanced Fund	**May**	**2.2%**	**3.4%**	**15.5%**
Fund Benchmark	*May*	*1.3%*	*5.7%*	*13.9%*
Maestro Cautious Fund	**May**	**2.0%**	**4.0%**	**13.1%**
Fund Benchmark	*May*	*1.0%*	*4.3%*	*9.5%*
Central Park Global Balanced Fund ($)	**Apr**	**1.5%**	**0.5%**	**7.8%**
*Benchmark**	*Apr*	*0.5%*	*1.5%*	*7.1%*
*Sector average ***	*Apr*	*0.2%*	*0.9%*	*4.0%*

* 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
** Lipper Global Mixed Asset Balanced sector ($)

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File 13. – Things almost worth remembering

How "long" is a "long bond"?

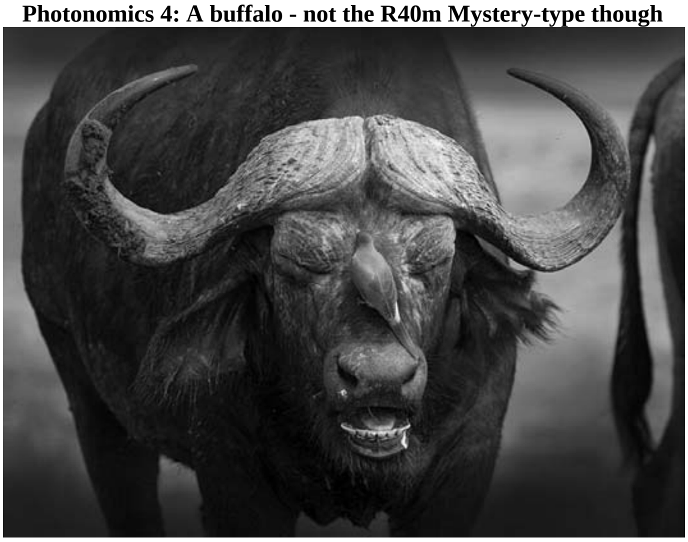
You may have heard many investment professionals talking of the "long bond", which usually refers to long-term government bonds. Way back when, if the yields on long-term US government bonds moved lower on a particular day, then traders would say "the long blonde is behaving herself". I guess that sort of dates me? The purpose of this drivel is to draw your attention to how "long" long really is? There was a time when a bond which matured in 30 years' time was regarded as the long bond benchmark; that is probably still true today but depending on market conditions governments and occasionally corporates issue shorter-term bonds and occasionally longer-term bonds. It provides a great deal of certainty to the issuer i.e. the government or corporate raising the debt (for that is what a bond is i.e. debt); they are able to raise funds at a given interest rate (usually) which obviously helps them with their planning. For the purchasers of long-term bonds, typically insurance companies who need to match their known liabilities with an asset of a similar term (age to maturity of the bond) long-term bonds can hold a great deal of appeal. With that by way of background you might be interested to know that early in May, construction equipment maker Caterpillar Inc became the first US company, excluding financials, to price a 50-year bond in nearly a year. The company priced $500m in "half-century" bonds at a price of 137.5 basis points above US Treasuries. So if the 30-year US bond traded at 3.0% for example, Caterpillar's bond would have been issued at 4.375%. More interestingly, the $500m bond issue attracted an order book of $8bn i.e. potential buyers' demand totalled $8bn for the $500m of available bonds. Interestingly, this is not the longest dated bond issued by Caterpillar; they have a "century bond" issued in 1997 that matures in 2097. So now you know how "long" *really* long-term bonds are! ☺

Photonomics 3: Stormy seas testing a lighthouse in Portugal

Equities, bonds, musical instruments, art and now bull?

Well, not quite; in fact quite the opposite. We have in the past brought you news about traditional investment markets, and non-traditional ones such as musical instruments and art. Now for the first time I am delighted to bring you something really African – the latest news from the buffalo market! I kid you not. A number of records recently fell at a game auction in Mpumalanga which reminded me of last year's interesting developments in the buffalo market which I never reported. I am sure global readers of *Intermezzo* in particular will find this interesting.

Photonomics 4: A buffalo - not the R40m Mystery-type though



In September last year, a record R40m ($3.8m) was paid for a stud buffalo bull called Mystery. This eclipsed the previous record for a stud buffalo of R26m and over-shadowed the bull sold for R20m for which deputy president of the ANC Cyril Ramaphosa famously bid R19.5m. While investment "creatures" like me and our team get excited about cash flow, PE ratios and earnings growth, what excites buffalo bull buyers is the size of their horns. In this regard Mystery trumped them all. His horns bore an incredible span of 135.6cm (53.4 inches). I suggest you measure that yourself to appreciate just how wide that is! Johan Rupert, the Richemont chairman, was a member of the consortium that bought Mystery. If you can't understand the economics behind these "trades" consider that, according to the Professional Hunters Association of SA, foreign hunters spent R1.24bn in SA in 2012. The stud buffalo are bought to breed wide-horned buffalo which are then used in the hunting trade to attract professional hunters. Rhinos are also big business but that is a story for another day, other than to share the following data; between 2008 and 2013 private farm owners lost 717 rhinos to poaching. Collectively more than 3 000 rhinos have been poached over that time, the lost value of which is estimated to exceed R1bn.

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The art market continues to soar

Speaking of records, interest investors would have noticed that the art market continues to set new records; descriptions of the market such as "unbelievable", "amazing" and "crazy" the order of the day. On *one night* in May, Christie's auction raised a total of $744.9m (that's R7.8bn on one night!) setting a new record for the highest total ever for a single art market auction. The previous record was held by Christie's who in November 2012 raised $691m at a single auction. Most of the buyers on the record night seemed to be Asian, which is a noticeable trend in art auctions these days. Simply put, although economies are not exactly roaring along at record growth levels and consumers across the world are under some pressure, we have the world's equity markets, bond markets art market and even buffalo markets at record levels. And I haven't even touched on property prices in London, Hong Kong and New York. Mmm… watch this space – this movie is getting very interesting indeed!

Photonomics 5: Grizzly bear in Yukon River

So what's with the pics?

Any similarity between the sense of danger lurking in these beautiful photographs and the current market levels at their dizzy heights is purely coincidental. I nonetheless hope you enjoy them – all through the courtesy of National Geographic's Photo of the Day series.

Table 3: MSCI returns to 31 May 2014 (%)

31-May-2014	Mkt	US$ perf (%)		
Region/Country (# Co)	cap U$bn	2013	1M	YTD
North America (705)	19,433	27.6	2.0	4.0
Canada (95)	1,369	3.3	0.7	4.4
US (610)	18,064	29.9	2.1	4.0
Europe (435)	9,120	21.7	0.2	3.8
Austria (8)	36.2	10.9	-1.3	-3.7
Belgium (11)	164	24.6	0.3	4.4
Denmark (11)	177	23.4	-1.2	13.8
Finland (12)	121	41.6	2.6	2.3
France (73)	1,399	23.3	-0.7	4.6
Germany (55)	1,259	28.2	0.1	0.0
Ireland (4)	42.0	38.9	-3.9	9.5
Italy (25)	347	16.9	-2.2	13.7
Netherlands (23)	358	28.5	0.8	-0.5
Norway (10)	117	5.3	3.1	8.8
Portugal (5)	25.7	7.5	-3.6	7.2
Spain (22)	494	27.7	2.0	9.9
Sweden (31)	424	21.4	0.3	1.0
Switzerland (38)	1,242	23.8	0.6	5.2
UK (107)	2,913	16.2	0.4	2.7
Israel (9)	68.4	8.0	0.5	15.9
Asia Pac (1003)	6,784	9.3	3.2	0.3
Japan (320)	2,639	24.9	4.0	-5.2
Australia (69)	1,065	-0.3	0.4	7.0
New Zealand (5)	16.8	6.2	-6.3	10.8
Asia Pac ex-Japan (683)	4,145	0.5	2.8	4.1
Asia ex-Japan (609)	3,063	0.7	3.7	3.1
China (140)	730	0.4	4.0	-4.3
Hong Kong (39)	383	8.1	3.8	2.3
India (69)	275	-5.3	9.3	16.6
Indonesia (30)	100.9	-25.0	0.1	21.3
Korea (104)	629	3.1	3.8	2.4
Malaysia (44)	149	4.2	1.1	1.0
Philippines (19)	37.9	-4.3	1.8	15.6
Singapore (30)	201	-1.8	1.3	3.2
Taiwan (106)	472	6.6	3.9	6.3
Thailand (28)	84.7	-16.9	-3.3	6.2
EMEA (139)	697	-8.0	5.1	1.0
Czech Republic (3)	9.9	-14.9	-1.9	6.5
Egypt (4)	8.2	6.2	-3.9	10.7
Greece (10)	23.9	46.2	-1.1	5.9
Hungary (3)	9.6	-9.0	9.8	-0.2
Poland (22)	66.6	-1.7	0.0	2.7
Russia (22)	208	-2.6	12.2	-10.2
South Africa (50)	300	-8.8	1.8	5.1
Turkey (25)	69.6	-28.1	9.3	21.6
Latin America (143)	742	-15.7	-0.4	1.3
Brazil (75)	421	-18.7	-2.0	2.5
Chile (21)	60.6	-23.0	1.1	-0.7
Colombia (15)	43.0	-23.7	0.0	5.8
Mexico (29)	200	-2.0	2.9	-2.1
Peru (3)	17.6	-31.0	-0.2	10.4
Developed Markets (1612)	32,927	24.1	1.6	3.3
Emerging Markets (822)	3,918	-5.0	3.3	2.5
World (2434)	36,844	20.3	1.8	3.2

Source: Merrill Lynch