INTERMEZZO

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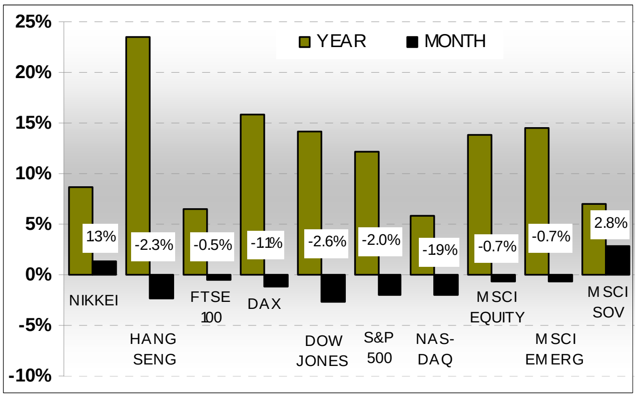
February in perspective – global markets
One of life's first lessons our parents try to teach us as young children is that "all good things come to an end". Of course we never listen; I mean how can the words "enough" and "chocolate or sweets" ever peacefully co-exist in the same sentence?! And how hard it is to learn the same lesson throughout the rest of our lives. Even if we understand the concept mentally, it is a hard one to learn experientially. And so it is that even if we suspected the markets were due to take a "breather", it is never pleasant when it occurs. Indeed, it can be most unpleasant at the best of times. Equity markets have been strong so far this year, continuing their rally since mid-2006, following the second quarter's China-induced wobbles. Since the trough only nine months ago, the SA equity market had risen 23%, the US market 19% and Germany 33%. Some emerging markets had risen by even greater amounts; India posted an 8% decline for the month. I will deal with some of the reasons for the recent market weakness below, but suffice is to highlight that the Japanese equity market was the only major one to register a positive return in February. Although the losses listed in Chart 1 don't look too severe, remember they only capture two days of the losses (February ended mid-week). Markets were trading at record levels two days prior to month-end. Since then markets that had risen the most also declined the most. For the week ended 2 March the Chinese market ended 5.6% lower, Japan 5.3% lower, Germany 5.6%, the S&P500 4.4%, Turkey 7% and Brazil 6.3%.The bond market has been relatively strong. Recent equity market weakness was caused, inter alia, by concerns about the state of the credit market; investors have begun to believe that interest rate relief may be forthcoming sooner than expected, hence the decline in yields and increase in bond prices. This trend has continued into March.

Chart 1: Global market returns to 28 February 2007



So what is happening out there right now?
What is behind the current turmoil and weakness on global equity markets? As far as I can ascertain, the more influential factors include the following:

- *The Chinese equity market*: I refer you to [last month's *Intermezzo*](), wherein we spent time looking at the huge gains Chinese equity investors had experienced recently. Despite the 131% increase in their market in 2006 prices have increased even further so far this year, which prompted the authorities to establish a special task team to investigate "illegal share trading" (a quick reminder - during 2001 and the third quarter of 2005 the Chinese equity market *declined* 50%). There have been some scary stories about ordinary people mortgaging their houses and using the proceeds to speculate in the market. News on this development triggered a 9% slide in the Chinese equity market on 27 February, which in turn set off a domino effect around the world.

- *Unwinding of the yen carry trade*: the "carry trade" involves investors borrowing in low-yielding currencies such as the yen, where interest rates are negligible, and investing in higher yielding currencies such as the rand. The current demand for "yield" (returns) in the world, particular as demographic changes (such as the aging population and declining number of contributors funding retirement schemes) has compounded the pressure to achieve minimum returns (to meet long-term pension liabilities). Consequently, the carry trade has become a very powerful force in the investment world today, as well as being a huge source of liquidity. Bank of Japan (BoJ) officials recently estimated that the "carry trade" could involve as much as $200 - $300 bn. With interest rates having begun to rise again – the BoJ raised rates from 0.25% to 0.5% in February – it is not unreasonable to expect the carry trade to unwind. It is not too surprising therefore to see the yen gain 3% against the dollar but 7% against the rand in the week ended 2 March. Given the recent Japanese interest rate increase and the nervousness in the markets, this factor is also exerting a negative influence on equity markets.
- *The quality of the credit market*: investment banks around the world and in the US in particular, have been merrily lending money to all and sundry, and making record profits in the process. The levels of debt, which have been magnified by hedge funds and unprecedented private equity activity (the latter two players typically leverage their positions through the use of additional debt) have soared to unheard of levels. It is not untrue to say that the credit market has "exploded" in the past few years. Much of this debt has been securitised, re-packaged and sold to retail investors. The concern has

justifiably been raised that the quality of much of this debt is “suspect” to say the least. The ongoing collapse in the US housing market, which has been widely covered in the traditional media, has merely compounded the problem. The fear that the credit market is on the verge of “imploding” (which may perhaps be too strong a term), is adding to the nervousness of investors at present.

- *The extent of recent gains*: we have alluded to this on many occasions (refer to the January edition of *Intermezzo* for a detailed discussion of this topic) but when reviewing the current equity market weakness, bear in mind that just about all equity markets were at record highs. As we know from the past, nothing lasts forever and yes, “all good things *do* come to an end”.
- T*he usual suspects*: (hedge fund burning, Greenspan, computer glitches) in times like this all sorts of reasons, many of them valid, are forwarded for the current equity market weakness. This time around these include a couple of hedge funds “getting it wrong” (this factor is a hardy annual, although even when true the markets have coped easily with the fall out); a computer glitch in the Dow Jones company, which at the worst possible time failed to correctly calculate the Dow Jones index for two minutes on 27 February, causing the US equity market to lose 2% in two minutes, having been down 3% already that day (very scary, and an indication of the extent to which computer and algorithmic trading now dominate the markets); and even the fact that former Fed chairman Alan Greenspan said in a speech that a recession in the US was probable (he later changed that to “possible”). Irrespective of the multitude of factors adding to the equity market weakness, you don’t need much to scare markets when they are in steep decline.

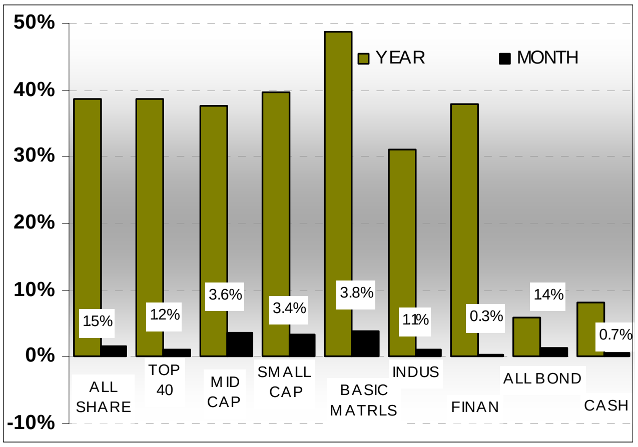
How long will this last? How “deep” will the declines be?
The simple and honest answer is “I have no idea”. Only time will tell. Market behaviour and psychology is about as large a field of academic study as mainstream economics these days, and I do not profess to be an expert in either. I would however point out the following factors which should, in theory at least, mitigate against further substantial declines:

- *The global economy is not overheated*: the world has grown strongly in recent years but there is no region that is seriously over-heating to the extent that substantial (and destabilising) changes in monetary or fiscal policy are called for.
- *But it is growing strongly*: the global economy is forecast to grow in excess of 5% this year despite a slowdown in the US. India is growing at 8%, China at 11%, South Africa at 5%. This environment is supportive of further equity market strength, not a collapse in markets. When BHP Billiton released their results in early February, CEO Chip Goodyear was asked about the sustainability of the companies markets and well-being. His answer was powerful: “The demand from India and China is real, and it is not going to go away”, he said. “It is not every day that you get a couple of billion people joining the world economy; and they will all need resources”.
- *Prospects for corporate earnings growth are good*: analysts are downgrading some forecasts, but the environment remains favourable and conducive to further corporate earnings growth. Balance sheets are strong; cash flows are even stronger.
- *Interest rates are not rising strongly:* with the odd exception (Japan and Europe spring to mind) central banks are either finished or close to the end of their respective interest rate tightening cycle. Expectations with regard to the interest rate environment are generally in touch with reality, and there should be no nasty surprises emanating from this quarter
- *Inflation remains low:* closely tied to the level of interest rates, inflation generally remains under control. This factor, possibly more than any other, provides a solid base for the future well-being of the equity environment
- *Equity market valuations are not stretched*: equity valuations are by no means a steal, but they are also not excessive in historical terms. We are nowhere near valuation levels that prevailed prior to the 2000/ tech bubble (with the exception of China perhaps) or the 1998 emerging market/LTCM crisis. In this respect a correction in equity prices may well restore the valuations to attractive levels that will allow for further commitment of capital.
- *The state of emerging markets*: this is a theme we have spent much time on, so should not be new to you. Unlike 1998 and prior years, it is emerging markets that today lead the world in foreign exchange reserves, trade surpluses and healthy fiscal management – look no further than South Africa for a good example of this (with the exception of the trade deficit in SA’s case). I refer you to the “Chart of the month” section for an example of this factor. It is the developed markets that have structural problems that beg for more conservative fiscal policies. They are the debtor nations of today, stuck with legacies from which they are seemingly unable to escape. The shift in economic power is moving from West to East faster than anyone expected a few years ago, and is a trend that is likely to become even more influential in future. The world is changing rapidly before our eyes; as global equity markets adjust to accommodate these changes, there are likely to be a few bumps along the way.

- *The ability of markets to handle crises*: at the risk of under-estimating the current equity market wobbles, I would point out that the world's financial markets seem to be more able to manage crises these days. Think of the current US housing bubble, the $1 trillion combined US budget and trade deficit, the $6bn hedge fund (Amaranth, and others) meltdown last year and the Refco crisis, the Middle East stock market crash last year – all of these were significant events that had global financial consequences, yet the markets seemed to have weathered these storms relatively well.
- *Global liquidity remains substantial*: this is another theme that we have spent much time on. There is little on the horizon that would indicate the level of a rapid and negative change in global liquidity is imminent.

Of course, none of the above factors will prevent equity markets from declining substantially from their current levels. However the best basis for analysing the investment environment is to concentrate on the underlying fundamental factors, and I hope you will agree that the above factors provide a strong case for stability, and indeed profitable investing, in the coming years. That doesn't mean we should not be alert to negative shocks and surprises. Maestro will continue to monitor the environment and exercise due caution and conservatism in the management of the assets which have been entrusted into its care.

Chart 2: Local market returns to 28 February 2007



February in perspective – local markets

Our market continues to be something of an anomaly, given its bias in favour or resource (basic materials) shares and their sensitivity to the weak rand. The SA equity market was on course to register another stunning return for February, but then general equity market weakness "got in the way" and it ended up "only 1.5%". It declined 4.2% in the last two days of February alone. The rand weakened 0.2% on the month, but declined quite sharply (3.4%) in the last two days (and has continued to fall into March). Its weakness supported basic material shares, which posted good gains during February. Understandably, financial shares were hard hit, losing just about all of the month's prior gains, and industrial managed to eke out a 1.1% return. The mid and small cap shares were again resilient, gaining 3.6% and 3.4% respectively. Amongst the sectors to post strong monthly gains were construction and materials (6.2%), software and computer services (5.5%) and platinum (5.4%). The oil and gas sector - read Sasol - lost 5.1%, media 3.9% and general industrial 3.4%. Similar to their overseas counterparts, local bond markets were quite strong.

Chart of the month

Table 1 depicts the top ten countries which at the end of November, held the largest central bank reserves. A decade ago a list containing these member countries would have been unthinkable – today it is a reality. No less than six (even excluding Hong Kong and Singapore as emerging markets) of the top ten holders of foreign exchange reserves are emerging markets. And what's more the trend in the movement from reserves (and to some extent political and financial power) from West to East, from Europe and the US to Asia, is likely to continue, if not accelerate.

Table 1: Central Bank reserves – Top ten in Nov 2006

Rank	Country	Current reserves ($)	Annual change (%)	Annual Change ($)
1.	China	1 012	28	224
2.	Japan	881	6	50
3.	Russia	281	71	116
4.	Taiwan	265	5	13
5.	Korea	234	13	26
6.	Europe	195	1	2
7.	India	168	22	30
8.	Singapore	134	17	20
9.	Hong Kong	131	8	9
10.	Brazil	83	29	19

Source: Merrill Lynch, Global Insight, IMF

Time for another smorgasbord

Before the events of the past few days and the resultant need to share my views of what has caused the recent market weakness, I had assembled a number of interesting items that I planned to share with you. At the risk of making this edition too long I list the items below in the hope that you will still find them interesting and informative. The items are in no particular order, and are quite random, although in one way or another they all constitute interesting aspects of the current investment environment.

- *The US goes global!* US investors are a particularly insular and patriotic bunch, who generally believe that other parts of the world are not worth knowing about, let alone investing in. It is rare that US investors move money abroad, particularly from money funds. Yet recent statistics from the US mutual fund industry show that in 2006 a remarkable 92.5% of US mutual fund flows were directed into international funds. Global funds captured $149bn of inflows and domestic funds just $12.1bn. In seven of the past eight months, US investors have pulled money out of money funds to invest elsewhere. The largest destination for these funds has been into emerging markets. Private investors now have 22% of their total equity assets in international funds.

- *How big is big?* We've asked this question before in an attempt to convey the sheer size of the Chinese (or Indian) market economy. Statistics released by the state electricity mouthpiece showed that in the past year China added 102 gigawatts of new capacity. To put that into perspective, that is more than the entire UK national grid and twice the total capacity of California (which, were it to be a country in its own right, would be the world's sixth largest economy).
- *Hedge funds increase their take:* According to Chicago based Hedge Fund Research, hedge funds attracted a record $126bn in new money last year, nearly triple that of 2005, increasing the total size of the industry to $1 430bn. (*Ed*: that's only 30% more China's foreign exchange reserves, which makes you realise just how large the latter are!) Of greater interest is that, according to Merrill Lynch, although the hedge fund industry constitutes only 3% of the asset management industry, they account for 28% of the industry's fee intake (revenue), up from 20% last year. The private equity industry is estimated to manage about 1% of the assets and take 8% of the revenue. No wonder investment banks are falling over themselves to either get into the hedge fund business or to buy into hedge fund or private equity groups.
- *Fund of hedge funds remain popular:* inflows into the fund of hedge funds industry continue to grow. The industry grew by 29% in 2006, up from 13% in 2005, despite the fact that the average fund of hedge funds return was lower than the hedge fund industry as a whole. There were 142 funds whose assets exceeded $1bn, up from 135 in 2005. The largest managers of fund of hedge funds were UBS followed closely by the Man group.
- *How strong is strong?* I have often referred to the strength of corporate cash flows in recent years and it was nice to read of a recent report that quantified this strength. Citigroup estimates that since 2003 UK companies have returned $231bn in the form of share buy backs and special dividends, which account for 63% of total dividends over the period. Across Europe, the amount returned to shareholders is $384bn or the equivalent of 56% of all regular dividends paid in the period. This is yet another factor behind the very large degree of liquidity in the investment world today.

For the record

Table 2 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. The December Quarterly Report in respect of the Central Park Global Balanced Fund is now available, should you wish to read it. Please contact me on andre@maestroinvestment.co.za if you would like to receive a copy.

Table 2: Returns of funds under Maestro's care

	Month	Return	Year to date
Maestro Equity Fund	Feb	**1.2%**	**5.9%**
Maestro equity benchmark *		0.5%	2.5%
JSE All Share Index		1.5%	3.8%
Central Park Global Balanced Fund ($)	Jan	**1.4%**	**1.4%**
Benchmark**		0.5%	0.5%

* 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

Whilst on the aspect of returns, I have taken the liberty of including for the second month a table of returns on the funds under Maestro's care – refer to Table 3. The purpose of doing this is to remind readers and clients alike, at a time when equity markets are declining sharply, of the long-term benefits of investing. I think it was John Templeton who said "it is about time (in the market), not timing". And Albert Einstein said "the greatest power in the world is the power of compounding". Timely and true reminders of the real value of investing.

Table 3: Maestro annual returns to 31 Dec 2006 (%)

SA equity returns	6 months	1 year	2 yrs	3 yrs	4 yrs	5 yrs
*Maestro average – **short-term, actively traded portfolios***	***26.0***	***34.1***	***36.6***	***45.3***	***47.8***	***56.8***
*Maestro average – **long-term portfolios***	***30.8***	***43.1***	***42.2***	***42.3***	***39.6***	***38.6***
Maestro equity benchmark *	23.5	40.5	40.3	38.7	32.5	28.2
JSE All Share Index	18.9	41.2	43.9	37.5	31.8	29.0

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

File 13: The most stupid thing I have ever heard!!
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.

During the past month I read about what must surely be the most stupid, not to talk of irresponsible, thing that I have ever heard of. Sadly, it is true. It must also constitute what can broadly be defined as one of the largest cases of money laundering you will ever read of, carried out by no one other than the US government and the Federal Reserve. In answer to the House oversight and government reform committee, Paul Bremer, the US's top official in Iraq and leader of the Coalition Provisional Authority (CPA) at the time, admitted that the US had disbursed $20bn in Iraq in the period between March 2003 and June 2004. Astonishingly, $12bn of this had been disbursed **in cash**!

Without trivialising the situation on the ground at the time, who in their right minds sends $12bn of cash into a war zone?! At the committee hearings, officials admitted to "inadequate controls and documentation" relating to the disbursement of the cash. They described an environment awash with $100 bills; one contractor received a $2m payment "in a duffel bag stuffed with shrink wrapped bundles of currency". On December 12 2003, the Fed shipped $1.5bn to Iraq, the "largest payout of US currency in the Federal Reserve's history". It was followed by more than $2.4bn on June 22 2004 and $1.6bn three days later. All in all no less than 360 tons (!!) of cash was airlifted into Iraq. In January 2005, Stuart Bowen, special inspector general for Iraq reconstruction, issue a report that found that $8.8bn sent to Iraq was still unaccounted for.