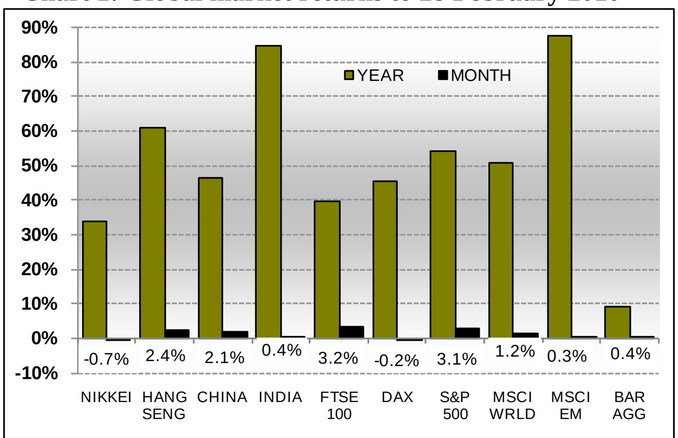
MAESTRO
INTERMEZZO
Investment Letter | 10th Edition | March 2010

February in perspective – global markets

Market movements in February were rather strange: virtually all US economic and consumer-related data were weaker than expected, yet the US equity market put in a strong monthly performance despite most other markets ending the flat or marginally lower. The UK was the only other equity market to post notable (3.2%) returns. Even emerging markets went nowhere fast – the MSCI Emerging market index rose only 0.3%. Bonds were also subdued, rising 0.4%. Currency markets were more volatile than normal though, as participants dealt with erratic and confusing news flow about the state of Greece's finances and of course all that *that* meant for Portugal, Ireland, Spain and of course numerous US states which share similar problems but are hidden under the federal nature of the US economy (more comment on that, below). The euro declined 1.8% against the dollar, bringing its 3-month decline to 9.1%. Sterling was also weak – it seems investors are only too familiar with the parlous state of the UK's finances. Sterling declined 5.0% against the dollar in February. Also noteworthy was the fact that, despite the firm dollar, commodity price rose. The CRB and GSCI commodity indices each rose about 3.5%, oil ended 6.8% higher and gold and platinum ended February 2.8% and 2.6% higher respectively. As usual, we list the returns of the MSCI Emerging market indices at the end of this edition.

Chart 1: Global market returns to 28 February 2010



What's on our radar screen?

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

- The SA economy: economic (GDP) growth during the December quarter of 2009 (Q4 09) came in at 3.2%, bringing economic "growth" for the year to -1.8%. The fourth quarter growth rate of 3.2% was an improvement on the first, second and third quarter growth rates of -7.4%, -2.8% and 0.9% respectively. Table 3 at the end of this report summarizes the data nicely. It was nice to see that eight out of ten industry sectors posted (positive) growth while seven out of ten sectors posted improved growth rates over relative to the third quarter. The annual inflation rate to January declined from 6.3% in December to 6.2%. Annual food inflation declined to 1.6% from 2.7% in December while services inflation declined from 7.2% to 6.8%. Core inflation i.e. the rise in prices excluding food and energy prices fell to 5.2% in January from 5.8% in December. We are still of the humble opinion that there is room for another small (25 [0.25%] basis points?) reduction in interest rates, notwithstanding the shocking hike in electricity tariffs.
- For those who are not familiar with this development (*Ed: Intermezzo* has a reasonable non-SA readership) let me tell you that the state-owned national electricity supplier, Eskom, last year applied for a 35% increase in electricity tariffs for *each* of the next three years. Needless to say, this was greeted with shock and dismay by the public and corporate users alike, especially seeing that it comes in the wake of a dismal track record of electricity supply to the country and poor governance at Eskom. The CEO departed recently under a cloud; it seems the Board was quite relieved to have found the opportunity to get rid of him although he has now sued the corporation for unfair dismissal and is claiming R84m – the circus is continuing in court. But back to Eskom; in the light of their request the National Energy Regulator (NERSA) granted Eskom increases of 24.8%, 25.8% and 25.9% for 2010, 2011 and 2012 respectively. It is interesting to note that, at their last meeting and as we reported last month, the SA Reserve Bank Monetary Policy Committee (MPC) raised their concern about the proposed tariff requests, which had not been decided yet, and decided to leave interest rates where they were pending the outcome of NERSA's decision. They also indicated that they had used a 25% increase in their inflation forecasts and implied in no uncertain measure that Eskom was holding the country ransom to higher rates as a result of their request and poor delivery. It will be interesting to see what the MPC has to say at their next meeting. Will they feel the need to grant the country some relief through lower rates, given that Eskom's huge tariff increase is little more than another indirect tax on the consumer? Time will tell.
- The final word on US fourth quarter GDP growth came in at 5.9%, an upward revision from the 5.7% reported earlier. That brought the year-on-year "growth" rate in the US for 2009 to -2.4%.

Charts of the month

In this section last month we drew your attention to the recent history of inflows into global mutual funds. Within the equity fund category, we noted the large inflow into emerging markets and the outflows from developed

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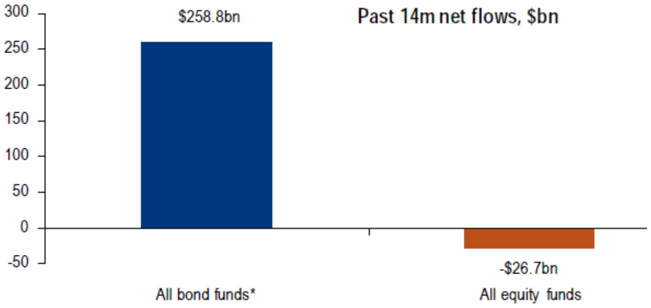
markets. This month we note in Chart 2, the cumulative inflows into US bond funds versus US equity funds since the start of last year. Despite the 72.7% (at the time of writing) rise in the S&P500 index since its trough in March 2009, US retail investors continue to pour money into bond funds, where they get very little yield, and take it out of the equity market. Strange that; isn't it amazing how often retail investors get it wrong? Or is it perhaps an indication of how disillusioned US investors are with equity returns over the past few years? Remember from our decade return chart last month that US equity investors lost 24.1% of their money over the decade, or 2.7% per annum over the past ten years. No wonder they are giving up on equities!

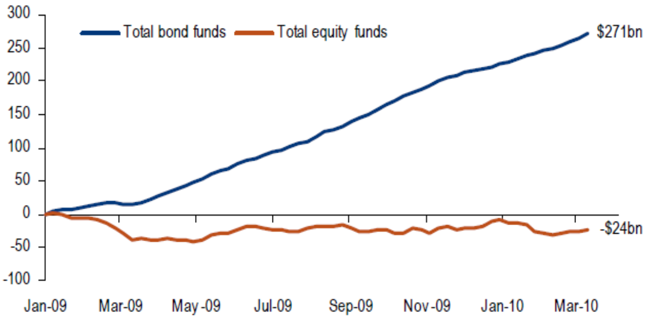
Chart 2: Net fund flows into EM and DM ($m)



Source: Merrill Lynch

In Chart 3 we show the total cumulative inflows, since the start of 2009, into bond and equity funds. The message is the same here, but one gets an idea of just how vast the cumulative difference is.

Chart 3: Net flows into equity and bond funds ($bn)



Source: Merrill Lynch

A few quotes to chew on

This following quote may seem stupid, but I can't tell you how many times it has proved to be accurate at times of acute market distress, for example in September 2008 when Lehman Brothers collapsed or in March 2009 when Citigroup nearly collapsed. It also comes from a person and institution which we regard highly, so it needs to be taken seriously. Michael Hartnett, the Chief Global Equity Strategist at Merrill Lynch always says: *"Markets stop panicking when governments start panicking"*.

"Although your Fund has outperformed its Benchmark, it should be recognized that the Fund's strong absolute returns are also attributable to the very strong performance of emerging markets and commodity producers from what would now seem very depressed valuations at the turn of the century. It would be extraordinary if your Fund were to enjoy a second consecutive decade with such favourable tailwinds. We are quick to caution Members that we expect real returns to prove much more elusive over the next decade." Allan Gray, Orbis Investment Management Chairman, writing in the December 2009 Report on the Orbis Africa Fund. The point here is not to cast doubt on that Fund but rather to draw your attention to wise counsel from an Investment Manager whose credentials are well established and highly regarded. We could not have expressed this sentiment better.

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 1: Returns of funds under Maestro's care

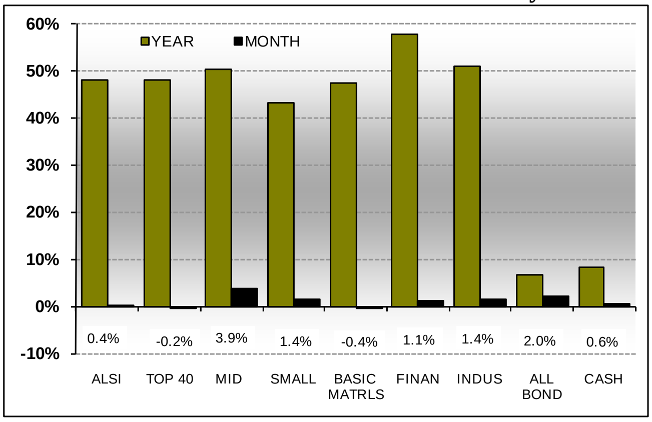
	Period ended	Month	Year to date	Year
Maestro Equity Fund	Feb	**1.8%**	**-2.9%**	**35.6%**
Maestro equity benchmark *	Feb	0.2%	-2.3%	51.8%
JSE All Share Index	Feb	0.4%	-3.1%	48.3%
Maestro Long Short Equity Fund	Jan	**-1.9%**	**-1.9%**	**8.8%**
JSE All Share Index	Jan	-3.5%	-3.5%	33.2%
JSE Financial and Indus 30 index	Jan	-1.1%	-1.1%	36.3%
Central Park Global Balanced Fund ($)	Jan	**-3.4%**	**-3.4%**	**11.0%**
Benchmark**	Jan	-1.4%	-1.4%	18.5%
Sector average ***	Jan	-1.9%	-1.9%	25.1%

* 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 ($)

February in perspective – local markets

February proved to be a flat month on the SA equity market. Despite a weaker (-1.6%) rand the Basic materials index actually declined 0.4% while the Financial and Industrial indices rose 1.1% and 1.4% respectively. Large caps declined 0.2%, Small caps rose 1.4% and the Mid cap index blew the lights out with a 3.9% return. Although we alluded to it last month, remember the base off which the annual returns are being measured is moving lower, which means that the annual returns to end-February rose sharply despite equities moving lower in January (-3.5%) and going nowhere in February(0.4%). By way of example, the annual return of the All share index to end-January was 33.2% despite the index falling 3.5% in January and the annual return to end-February rose to 48.3%, despite a return in February of just 0.4%. The respective annual returns to end-January and February of the Industrial index are 33.1% and 51.0%, while the annual return of the Maestro equity benchmark to January and February was 35.8% and 51.8% respectively. These numbers are large and will no doubt attract media comment, but remember when analyzing the returns that the base is extreme, which leads to "extreme" returns. The "base effect" will unwind sharply from next month, as the market trough (on 9 March 2009) will fall outside the annual return measurement period.

Chart 6: Local market returns to 28 February 2010



The Maestro Market Commentary

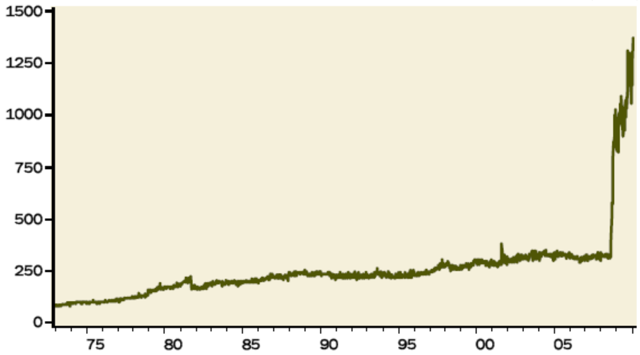
Many of you would by now have received our latest *Market Commentary*, which reviews market behaviour during the last semester and sheds light on our views for the months ahead. If you have not received a copy of this document but would like to, email me on andre@maestroinvestment.co.za and I will send you a copy.

As usual there was so much to include in the *Market Commentary* which for time's sake, we had to exclude. So I am taking the liberty of "cheating" and will include a couple of extra charts and thoughts in the next few editions of *Intermezzo*. If nothing else it may bring about the realization that there is never a document that "captures it all" or can ever be described as "up to date". Before the proverbial ink is even dry, these documents date. So with your permission, please see our attempt as one to keep you informed on an ongoing basis about market developments. Whether it be through *Intermezzo* or the monthly letters accompanying your statement, or our respective Fund Summaries or Quarterly Reports – all of these documents represent our ongoing dialogue with you, our clients, to keep you abreast of our thoughts and engagement with the market interface.

We came across two very useful charts that succinctly illustrate two issues we raised in the *Market Commentary*.

The first one was the "wall of money" that we listed as a positive feature in support of global equity markets. There is a huge build-up of cash in the global system, partly as a result of the trillions of dollars, etc that central banks have pumped into the global economy to support it during the credit crisis. This cash is sitting in bond funds, banks, money market fund, and some of it (but not all as we saw earlier from the mutual fund inflows) in the equity markets. Chart 7 shows the build-up of cash in the US banking system. While this may be supportive of the equity markets in a roundabout way, it is also symptomatic of the manner in which banks are hoarding cash rather than lending it out, which is traditionally their primary role in an economy. Whichever influence you think is greater, the chart shows just how large and unprecedented this cash hoarding is. And don't' think this is a US problem only; we read during the past month that in China, household and corporate deposits in the banking system are now equivalent to 150% of GDP.

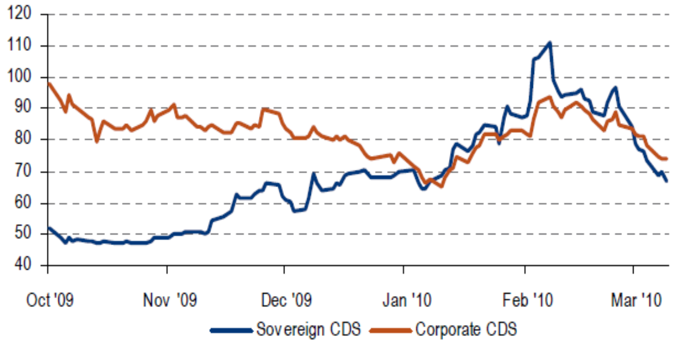
Chart 7: Cash assets for all US commercial banks ($bn)



Source: Gluskin Sheff

The second aspect we wish to expand on is that of "Sovereign Risk," one of Maestro's "Big Picture Themes". In the *Market Commentary* we noted that the issue of Sovereign Risk revolved around the creditworthiness of governments to honour their debt (liabilities). One very quantifiable measure of this is to follow the indices that track the cost of insuring such debt, which in our industry jargon we call "credit default swaps" or CDS's. Chart 8 shows two indices which track the cost of insuring sovereign (government) and corporate debt in Europe. Although the cost of the former has again slipped below the cost of the latter as the market starts to believe that some form of resolution to Greece's problems will be found, you can see from the chart that there was a time recently that it cost more to insure government debt than corporate debt. In other words, people trusted large corporates more than governments in terms of honouring their debt obligations. What is also rather alarming to note from the chart is the extent to which global investors' views toward government debt have changed since October 2009. At that stage, it cost twice as much to insure corporate debt, yet the cost of insuring government debt has escalated so much that in early February it cost about 22% more to insure government debt than corporate debt. This is a complicated aspect for the lay investor to understand, but we think it sufficiently important to bring to your attention as a very powerful force on markets in the coming months and years. We continue to watch the situation closely and continue to regard Sovereign Risk as a very disruptive influence.

Chart 8: Western European sovereign CDS vs European corporate CDS



Source: Merrill Lynch

Speaking of mistrust in governments, early in March we were afforded an opportunity of quantifying global investors' perceptions of SA. At the same time as President Zuma was defending his lifestyle in the UK and arm-wrestling with the infamous tabloid media, the SA Treasury issued $2bn of 10-year debt i.e. they issued a bond that matures in 2020. Demand for the bond was heavy - the issue was more than three and a half times over-subscribed - although the government only issued $2bn as planned. More importantly the issue was priced at 197 basis points (bps) i.e. 1.97% above the US 10-year bond yield, which meant that the SA bond carried a coupon of 5.5%. In other words, government raised $2bn in the global bond market that will cost them only 5.5% for the next ten years. The 197 bps was lower than the 375bps and 240bps that investor demanded on the two occasions that last year when SA issued a similar bond. So there you have it; global investors have "spoken". They are prepared to hold SA debt – and a lot of it, it would appear – and don't perceive it as being that risky, despite all the antics of our colourful politicians. Global investor attitudes like that also go some way to explaining why the rand remains firm, a scenario we believe will continue for some time.

Table 2: MSCI returns to end-February (%)

	Feb'10	YTD
Peru	7.3	-3.5
Philippines	5.4	-0.9
Colombia	4.5	6.8
Brazil	4.4	-7.1
Thailand	4.2	-1.3
Mexico	4.2	-2.3
LatAm	**4.1**	**-5.2**
Hong Kong	3.8	-3.0
Australia	2.8	-4.4
China	2.2	-6.6
Israel	2.0	2.3
Egypt	1.5	8.9
India	1.3	-4.1
MSCI DM	**1.2**	**-3.0**
Japan	1.1	3.0
AP ex Japan	**1.0**	**-5.4**
Singapore	0.7	-5.4
Malaysia	0.7	-0.3
Pakistan	0.4	1.9
MSCI EM	**0.3**	**-5.4**
South Africa	-0.4	-5.8
Morocco	-0.7	3.6
Chile	-1.0	2.1
Korea	-1.1	-5.9
EMEA	**-3.0**	**-3.6**
Indonesia	-3.7	-1.7
Taiwan	-3.7	-9.9
Czech	-4.4	-2.5
Argentina	-4.7	-7.8
Poland	-5.0	-6.1
Hungary	-5.1	-4.4
Russia	-5.2	-3.0
Turkey	-12.4	-10.4

Source Merrill Lynch

And now, for something different …

Readers will know that I am fond of good photographs, particularly those that teach us new things or show us a familiar thing in a new way. So for something different, we are introducing a new section into *Intermezzo* in the next few months. We call it "Photonomics"; aerial photographs, per kind favour of Google Earth, of "sights and wonders" from the regions of the world we read about so many times during our working day. You can take a closer look for yourself – it's all out there on the web. Our intention is merely to encourage you to look it up for yourself, and of course to brighten up your day. To start off with, we begin with a view of the Forbidden City in Beijing - enjoy.

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Photonomics: The Forbidden City, Beijing

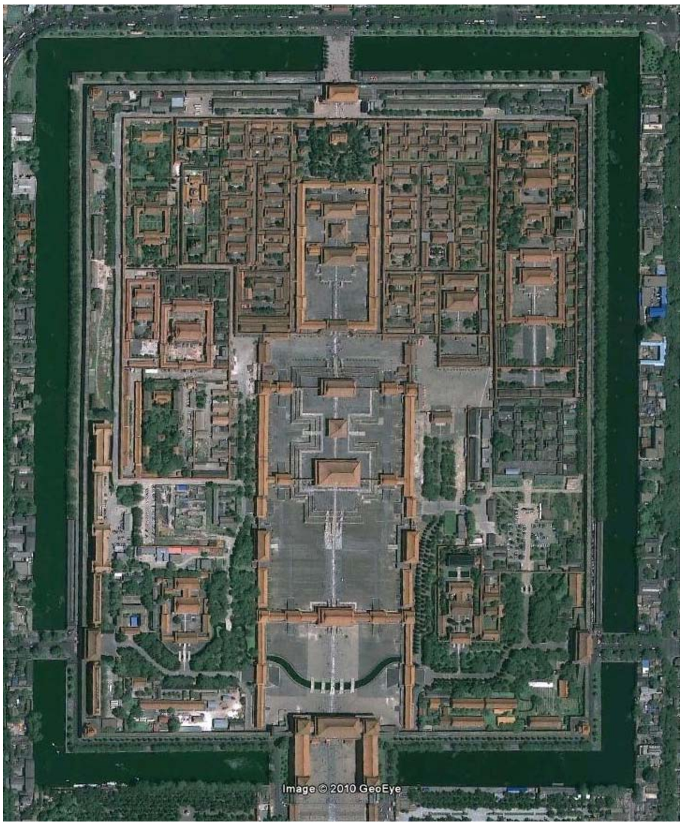

Table 3: Contributions to SA economic growth by sector

Contributions of the annualised percentage change in seasonally adjusted real value added by industry to the annualised percentage change in seasonally adjusted real GDP

Industry	Relative size (%)	Q-Q growth (saar) %					Contribution to saar growth (% points)			
	Q4'09	Q4'08	Q1'09	Q2'09	Q3'09	Q4'09	Q1'09	Q2'09	Q3'09	Q4'09
Agricultural, forestry, fishing	2.1	5.6	-5.6	-15.8	-11.8	**-7.6**	-0.1	-0.3	-0.24	-0.2
Mining & quarying	5.2	0.1	-30.7	15.8	-5.8	**4.6**	-1.7	0.8	-0.3	0.2
Manufacturing	**15.1**	-17.4	-25.5	-11.1	7.6	**10.1**	-4.4	-1.6	1.1	1.5
Electricity, gas & water	2.0	-0.1	-8.1	1.9	4.2	**0.9**	-0.2	0.0	0.1	0.0
Construction	3.3	6.3	10.7	8.7	6.1	**3.6**	0.3	0.3	0.2	0.1
Wholesale, retail trade & catering	**11.8**	-0.3	-2.4	-5.9	-1.1	**-0.7**	-0.3	-0.7	-0.1	-0.1
Transport & communication	9.1	1.6	-2.1	-1.0	1.2	**1.9**	-0.2	-0.1	0.1	0.2
Finance, real estate & business services	**21.3**	7.5	-2.3	-3.8	-1.5	**1.1**	-0.5	-0.8	-0.3	0.2
General government	**13.8**	6.2	2.1	3.1	4.9	**7.0**	0.3	0.4	0.7	1.0
Personal services	5.9	1.5	2.7	3.3	3.5	**3.1**	0.2	0.17	0.2	0.2
Total value added	**89.7**	-0.3	-7.6	-2.4	1.4	**3.5**	-6.7	-2.1	1.3	3.1
Taxes less subsidies	10.3	-4.0	-6.4	-6.9	-3.4	**0.7**	-0.7	-0.7	-0.4	0.1
GDP at market prices	**100.0**	-0.7	-7.4	-2.8	0.9	**3.2**	-7.4	-2.8	0.9	3.2

1. The relative size of each industry for the fourth quarter of 2009 is the share of its seasonally adjusted real value added of the seasonally adjusted GDP for the third quarter of 2009. Similarly, the relative size of taxes less subsidies on products is the share of its seasonally adjusted value of the seasonally adjusted GDP for the third quarter 2009.
2. The contribution is calculated by multiplying the percentage change of each industry (and taxes less subsidies on products) by its share of GDP in the previous quarter (i.e. its relative size).

Source: Vunani Securities