MAESTRO

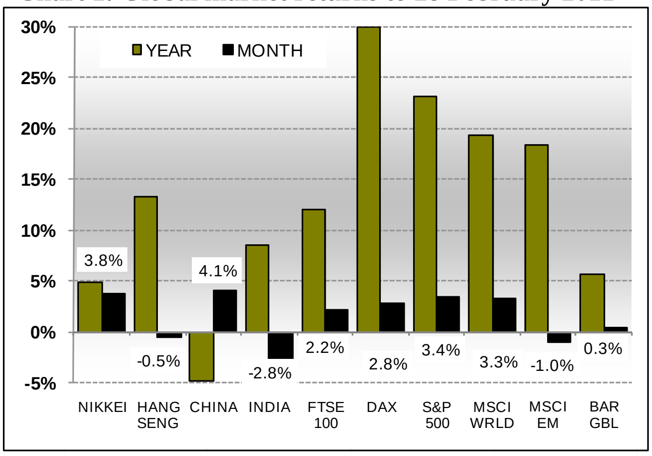
INTERMEZZO

11th Edition | March 2011

February in perspective – global markets

Similar to January, February was not a market for the faint-hearted investor. We moved into the month, with a hangover of North African “people power”, fresh from having toppled the government in Tunisia. Egypt was quick to follow, the significance of which was not lost on investors, particularly as it spread to Libya to the west and closer to Saudi Arabia in the east. That was enough to trigger a sharp uptick in the (Brent) oil price, which sailed through $110 level like a hot knife through butter. Not to be outdone, prices of other commodities, especially food or “soft” commodities as they are called also rose sharply; refer to the section below on commodity prices for more perspective. Many of them are either at or close to all-time highs. Elsewhere, Chinese authorities continued to apply the brakes in an effort to curb price rises; they increased interest rates again and raised the requirements for banks’ reserve holdings. And while all eyes were on the Arab world, *China quietly slipped past Japan to become the world’s second largest economy*.

Chart 1: Global market returns to 28 February 2011



The Great Rotation, to use Merrill Lynch’s phrase, continued as investors pulled money from emerging markets and into developed markets. That lead to another month of robust returns from the latter– the MSCI world index rose 3.33% - and weak returns from the former – the MSCI emerging markets index declined 1.0%. India declined 2.8% to bring its year-to-date return to -13.1% but China managed a 4.1% gain (year-to-date return of 3.5%). Russia was firm, up 5.3%, on the back of the rampant oil price. Perhaps the biggest surprise for us was the 4.5% and 4.3% returns of the S&P mid and small cap indices respectively. The S&P (500) large cap index rose 3.4%, Germany 2.8% and Japan 3.8% on the back of a weaker yen. So all in all, barring a few markets, market behaviour in February would have pleased most investors.

What’s on our radar screen?

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

- *The SA economy* grew at 4.4% in the final quarter (Q4) of 2010, up from 2.7% during the third quarter. For the year as a whole, the economy grew 2.8%, better than the *decline* of 1.7% in 2009. Q4 growth was boosted by strong external demand, with the sectors that are affected by the latter (agriculture, mining and manufacturing) contributing 40% of the growth in the quarter. During Q3 these sectors contributed 50% of growth. Table 1 provides a breakdown of the sectors and their respective contribution to the overall level of growth (saar refers to seasonally adjusted, annualised rate).

Table 1: SA economic growth: breakdown by sector

	yoy %		qoq % saar	
	2009	2010	Q3	Q4
Agriculture	-3.0	0.9	16.3	12.5
Mining	-4.2	5.8	33.7	17.1
Manufacturing	-10.4	5.0	-4.9	4.1
Electricity	-1.6	2.0	-2.2	5.6
Construction	7.4	1.5	0.8	0.2
Domestic trade	-2.5	2.2	3.3	3.5
Transport	0.6	2.9	3.0	4.2
Finance	0.9	1.9	1.4	1.7
General govt.	4.1	3.0	0.4	5.3
Personal services	-0.3	0.6	3.1	3.3
GDP	-1.7	2.8	2.7	4.4

Source: Deutsche Securities

Still on the SA economy, the annual inflation rate in January rose to 3.7% from 3.5% in December. The 2.3% month-on-month increase in food prices was the biggest monthly increase since December 2001. It is interesting to note that services inflation, which constitutes 45.8% of the consumer price index (CPI), declined to 4.7% from 5.1% in December. But this positive effect was undermined by the increase in prices of basic necessities, which constitutes 33.0% of CPI, which rose to 5.4% from 4.4% in December. Core inflation rose 3.4% from 3.6% in December. Given the respective bases and underlying pressures, it looks like we are approaching the trough in core inflation, and it is likely to rise in the second half of 2011. Maestro’s view on interest rates, for the record, is that we are likely to see the first hike in rates by the SA Reserve Bank in the second half of this year (more likely towards the end of the year). Back to the data, December retail sales rose 1.6%, bringing the annual gain to 8.3%, an increase from November’s annual rate of 8.0%. And finally, the Quarterly Labour Force Survey showed that the SA unemployment rate declined from 25.3% in the September quarter to 24.0% in the December quarter (Q4). As for who is creating jobs, during Q4 government created 148 000 jobs, the manufacturing sector 70 000 and the trade sector 28 000. The finance sector lost 31 000 jobs (and you thought investment managers made a lot of money!☺) while the construction industry lost 20 000 jobs.

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- *The US economy:* fourth quarter US economic growth was revised down from 3.2% to 2.8%. Other key revisions were those to personal consumption i.e. spending by the long-suffering US consumer, from an initial 4.4% to 4.1%, and very importantly a huge revision in the state and local government sectors, from an initial *decline* of 0.9% to -2.4% (refer to the Chart of the month section, below). We continue to be very concerned about what is happening at the US state and local government level and this type of data merely reinforces our concerns. These sectors are likely to deteriorate at an even sharper rate as the year progresses, as fiscal stimulus fizzles out and austerity measures imposed by the states kicks in. You will hear a lot more about this topic as the year progresses.
- *The Chinese economy:* eyes remain finely tuned to Chinese inflation; the annual inflation rate in January was 4.9%, up slightly from December's 4.6%. Perishable food prices were up 10.3% year-on-year. The tightening of monetary policy in China continues, with the reserve ratio for banks being increased by 0.5% for the second time this year, to 20.0%. In addition, the government raised interest rates by 0.25%, the third increase in the past four months, in an effort to curb rising prices. And just to repeat it again, *China officially overtook Japan as the world's second largest economy behind the US*. It seems like only yesterday that we wrote about China overtaking France and Germany to become the fourth largest economy! It is an excellent example of how rapidly the world is changing.
- *Global emerging markets:* although we don't report on all the emerging market growth rates, it's useful to provide a quick update on a selection of data that emerged in the past month. The Indonesian economy grew at 6.9% in the December quarter (Q4) and inflation concerns there saw interest rates being lifted 0.25% to 6.75%, the first increase in two years. We have already reported the 10.3% economic growth in China in 2010, but it was surpassed by the 14.5% growth rate of Singapore (12.5% in Q4), which now stands as the world's fastest growing economy in 2010. Taiwan grew 10.5% in 2010, India 9.8%, Thailand 7.8%, Philippines 7.3%, Malaysia 7.2%, Hong Kong 6.8% and South Korea 6.1%. So much for Asia. In Latin America, Argentina grew 9.1%, Brazil 7.7%, Chile 5.2% and Mexico 5.0%. The odd one out is Venezuela, which *shrank* 1.9%. In short, it is not true to think of the world as having gone "ex-growth". These numbers prove there is more than sufficient of it right now; commodity prices are confirming this.
- *The UK economy:* Fourth quarter UK economic growth was revised down from -0.5% to -0.6%. UK growth for all of 2010 was 1.5%.

Commodity prices are surging around the world

As you know we are watching commodity prices very closely, as is the whole investment community. Sadly, February brought no relief in this regard. To make matters worse, the prospects for soft commodities show no sign of improving. Late in February the US Department of Agriculture (USDA) warned that prices of grain and oilseeds were likely to remain high despite increased plantings of corn and soya beans. The USDA said that increased exports and demand for ethanol will keep prices high. Ethanol industry consumes about 36% of US corn crop. The US exports about half of the world's corn and a third of the world's soya beans. Chart 2 shows that the prices of core crops are getting close to the peaks of 2008 which brought about riots around the world, sparked by soaring food prices. One of the catalysts for the current unrest across the Arab world is the hardship of poor people, exacerbated by rising prices of basic foodstuffs. This theme – which lies comfortably within our **Big Picture Themes** of *The security of (commodity) supply* and *Climate Change* - is already a major theme for investment markets in 2011.

Chart 2: The core crop prices are stoking food prices

Source: FT.com

Other commodity prices are also rising rapidly. The prices of sugar and bananas are being affected by the floods in Australia; sugar is close to an all-time high. Arabica coffee beans are at their highest level since 1977 on the back of a poor coffee crop in Columbia. Cocoa prices are at a 33-year high after all the trouble in Ivory Coast. Clearly, this is bad news for chocoholics and coffee drinkers.

Chart 3: Coffee prices approaching all-time highs

Source: FT.com

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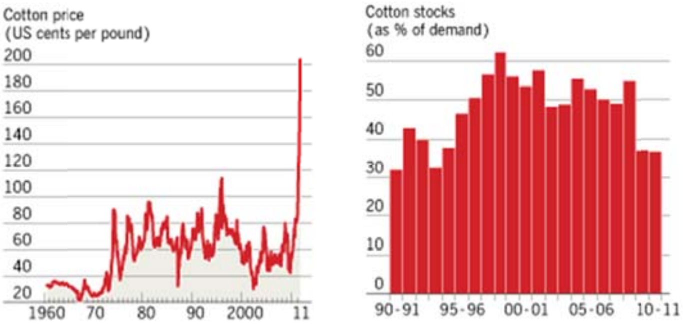
But perhaps the most spectacular rise of all is that of cotton, which recently broke through the $2 per pound level, on the back of declining stock levels, soaring demand from China, poor crops in Pakistan and export restrictions in India. Chart 4 depicts the recent price history of cotton.

Chart 4: Cotton prices and stock levels



Source: FT.com

The above comment applies to "soft" (food) commodities, but the same is true for "hard" commodities such as metals and oil. We all know what is happening to the price of oil, but did you know that the price of silver is closing in on a 30-year high? Chart 5 shows its recent history. Although other prices have been firm in recent months, there doesn't seem to be as much upward pressure on hard commodities as there is on the soft ones. But the point remains that we have to be vigilant about the impact and consequences of rising commodity prices in general, coming as they do at a time when firms still have very little pricing power and consumers have little ability to withstand further increases in prices, particularly food prices.

Chart 5: The silver price – no longer "poor man's gold"

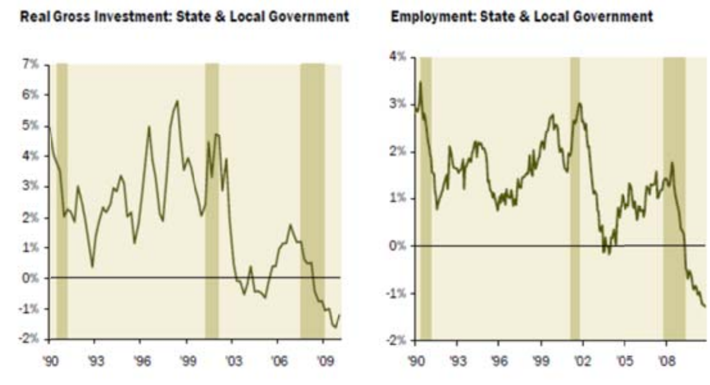
Source: Merrill Lynch

Chart of the month

In the [January issue of *Intermezzo*] we referred to the US municipal (muni) market which is in a bad state - no pun intended - and represents, at least in our opinion, another risk we need to keep an eye on. It has been a stable market for years, one widely used as a source of tax-free, high yield income; a bit like a tax-friendly money market fund. However, it delivered a return of -1.0% in January, and is down 5.2% for the three months to end-January. Its annual return to January was a paltry 0.7%, after rising 14.5% and 2.3% in 2009 and 2010 respectively. The muni market is usually characterized by net inflows, but in December US investors pulled $12.4bn from this market and in January they withdrew another $12.9bn. This topic is worth a report in itself, but time and space preclude such a discussion. Suffice at this stage is to share the reasons for our concern. Very simply, as the finances of many US states come under increasing pressure, the risk they represent is increasing, as is the risk of a default. Given that some of the states are large in global terms, some of the states represent a material risk not only to the US economy but to the world as well. Not all states are in the same position though; some are stronger than others. Taken as a whole though, there is reason for concern. Chart 6 shows the annual real gross investment and employment by state and local government. After the US consumer, state and local governments are the second largest contributor to the US economy. The charts speak for themselves.

Chart 6: US state and local government cutbacks

Annual percentage change



Shaded region represent periods of U.S. recession

Source: Gluskin Sheff

February in perspective – local markets

On the face of it the SA equity market posted decent returns in February, although there is more to the markets than meets the casual eye. The basic material index lead shares higher, rising 4.7%, thanks to very strong commodity prices. But it would have been a lot higher were it not for the strong rand, which detracted from returns towards the latter half of the month. Financials struggled amidst sluggish trading conditions (just look at the poor results being posted by the banks at present) and ended the month down 0.4%. Industrials rose 1.9%, but it is worth highlighting that the year-to-date returns for the financial and industrial indices are still firmly negative, at -1.9% and -2.3% respectively. The year-to-date returns for the mid and small cap indices

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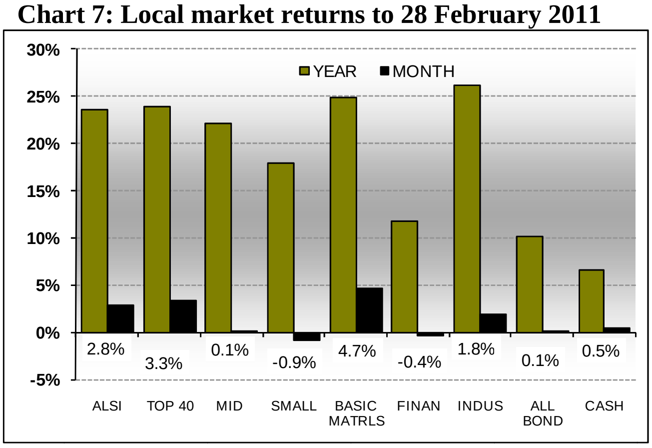
are even worse, at -4.7% and -4.5% respectively, although mid caps managed to squeak home in February with a positive return – just 0.1%. Small caps ended down 0.9%. The best performing sectors were oil and gas, up 9.8%, gold mining 9.7% and media 7.0%, while the construction and materials (-9.5%) and electronic and electrical equipment (-8.1%) brought up the rear. And yes, many of you would have noticed that around mid-month, *the All share index touched a new, all-time high,* before retreating into the end of the month.

Chart 7: Local market returns to 28 February 2011



A few quotes to chew on

We commented on surging commodity prices above; the following comment should be seen in that context. The three largest iron ore producers, Vale, Rio Tinto and BHP Billiton, are currently negotiating quarterly iron ore contract prices with clients (the larger steel makers in Asia and Japan). All three companies recently posted record results and the outlook for them looks rosy indeed. Vale Chief Financial Officer (CFO) Guilherme Cavalcanti said recently that he expected the market tightness to continue for three to four years. "This is the greatest moment for the company so far, but the best is yet to come".

Moeletsi Mbeki, political analyst and brother of former SA President Thabo Mbeki, recently wrote an article which offered a candid assessment of the likely outcome of the current path adopted by the ANC and government. Entitled *Corruption and dependence: SA's road to ruin or salvation?* he concluded as follows: "Twenty years ago the famous SA scenario analyst Clem Sunder said South Africa was approaching a cross roads: one road was the high and the other was the low road. The high road, which obviously he recommended, he said would lead to democracy, political stability and prosperity. Today South Africa is approaching another critical point in its history. In 1994, the leaders of South Africa chose the high road and adopted an inclusive political and economic model. Today the ANC government seems determined, despite its rhetoric, to follow the low road. The important question is whether, by following the low road, the ANC will lead the country to ruin or whether it will lead to the ANC's own ruin. An equally important question is will the ANC's ruin be the salvation of the country as happened with the National Party?" If you would like to read the article, please let me know and I will email you a copy.

We referred to the rise in food prices, above. In an article just released, the *UN Food and Agricultural Organization* (FAO) has issued a stark warning. Commenting on the fact that the FOA food price index has just reached a record high at the end of February, the FAO said that "the world may need to get used to higher food prices". Whilst admitting that the recent higher prices are being affected by temporary factors such as weather, it continued "... nevertheless, the main reasons for rising demand for food reflect structural changes in the global economy that will not be reversed".

For the record

Table 2 lists the latest returns of the mutual funds under Maestro's care. You can find more detail by visiting our website at www.maestroinvestment.co.za. Returns include income and are presented after fees have been charged. Please note that from last month we included in the table the returns of the three funds which form part of Maestro's retirement solutions. All three these funds are relatively new – they are just more than one year old – but they form an increasingly important part of our business, so we have decided to include their returns on a monthly basis. 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 Fund	**Feb**	**-0.4%**	**-5.7%**	**15.0%**
*Maestro equity benchmark **	*Feb*	*2.5%*	*0.1%*	*22.5%*
JSE All Share Index	*Feb*	*2.8%*	*0.6%*	*23.6%*
Retirement Funds				
Maestro Growth Fund	**Feb**	**-0.7%**	**-4.1%**	**11.4%**
Fund Benchmark	*Feb*	*1.9%*	*0.3%*	*18.2%*
Maestro Balanced Fund	**Feb**	**-0.6%**	**-3.1%**	**10.0%**
Fund Benchmark	*Feb*	*1.7%*	*0.4%*	*16.6%*
Maestro Cautious Fund	**Feb**	**0.1%**	**-2.1%**	**10.3%**
Fund Benchmark	*Feb*	*1.1%*	*-0.1%*	*13.4%*
Central Park Global Balanced Fund ($)	**Jan**	**-1.6%**	**-1.6%**	**8.9%**
*Benchmark***	*Jan*	*1.0%*	*1.0%*	*10.3%*
*Sector average ****	*Jan*	*1.0%*	*1.0%*	*10.4%*

* 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 ($)

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File 13: Information almost worth remembering

The law of large numbers revisited

Regular readers are aware that we sometimes list a couple of "standard facts" but ones that we need to dwell on because of the sheer size of the matter at hand. So, for example when we talk of urbanization in South Africa or China, the process is the same but the numbers are such that the consequences are vastly different. This month we have a good example. The Head of the Civil Aviation Administration of China announced in February that China intends to build another 45 airports in the next five years. The total investment by the government in the aviation sector alone between now and 2015 would be $228bn. To put that into perspective, that amount is 59% higher than the $143bn (R1 trillion) the SA government is committing to *total* infrastructure over the next three years. Many people are concerned that China's actions will lead to excess capacity; of the 175 commercial airports in China at present, 130 of them are running at a loss.

We all make mistakes; some are just bigger than others

It is never good to gloat when other investment managers make mistakes; we all make them. In fact the investment manager who says he has never made a mistake i.e. a bad investment decision, is lying. That said, I often detect a view amongst investors that large institutions don't make mistakes, or at least never make large ones. Here's a story to de-bunk that theory. It is an old one, but I keep forgetting to share it! For overseas readers who may not be aware of the Public Investment Corporation (PIC), it is the state entity that manages the government pension funds; it is by far the largest investment manager in the country. In October last year it was reported that the PIC had written down its investment in the AfriSam consortium, a black economic empowerment (BEE) deal it had facilitated when Holcim disinvested out of the country in 2008. At the time, the PIC deal helped the (BEE) Bunker Hills consortium to conclude the deal whereby they bought 85% of Holcim's 54% stake in Holcim SA as well as Aveng 46% stake. That resulted in the PIC landing up with a 20% stake in Bunker Hills, at a cost of R6bn. At the time PIC CEO Brian Molefe trumpeted the deal as a landmark BEE deal. Privately many questioned the merit in the deal, particularly as Bunker Hills included amongst its members family of high-ranking politicians and government officials. Those of us in the industry – Maestro clients had an interest in Aveng shares in prior years, and we held Aveng in high regard – perceived the deal as risky and certainly not supported by the fundamentals. Now we hear that the PIC's investment has been written down to R1.2bn i.e. the PIC incurred a loss of R4.8bn i.e. it has lost 80% of its investment. I guess we should not ask why Brian Molefe is no longer around. But one wonders how the average government employee, whose retirement funds were used to finance the deal, feels about this loss? My guess is they probably don't even know about it.

Table 3: MSCI returns to 28 February 2011 (%)

	Feb'11	YTD	2010
South Africa	6.4	-6.7	30.7
Russia	6.3	10.6	17.2
Indonesia	6.0	-4.5	31.2
Thailand	5.6	-3.7	50.8
EM EMEA	**4.8**	**0.0**	**20.9**
Japan	4.5	4.7	13.4
Morocco	4.4	8.2	10.8
Hungary	4.1	16.2	-10.7
Australia	3.9	1.5	10.0
MSCI DM	**3.3**	**5.6**	**9.6**
Brazil	2.9	-1.5	3.8
LatAm	**1.9**	**-2.8**	**12.1**
Peru	1.2	-11.0	49.2
Mexico	0.8	-2.1	26.0
Poland	0.6	2.1	12.6
Egypt	-0.5	-21.5	9.5
MSCI EM	**-1.0**	**-3.8**	**16.4**
Czech	-1.4	7.6	-7.4
Philippines	-1.4	-11.7	30.3
China	-1.8	-2.3	2.3
India	-1.8	-14.7	19.4
AP ex Japan	**-1.9**	**-3.3**	**15.0**
Malaysia	-2.1	-1.3	32.5
Turkey	-2.4	-12.0	18.4
Colombia	-2.4	-4.5	40.8
Chile	-2.8	-11.8	41.8
Hong Kong	-3.3	-1.7	19.7
EM Asia	**-4.0**	**-5.4**	**16.6**
Singapore	-5.1	-5.3	18.4
Korea	-6.6	-4.6	25.3
Argentina	-8.1	-9.1	70.1
Pakistan	-8.6	-6.3	19.5
Taiwan	-8.8	-5.9	18.3

Source: Merrill Lynch