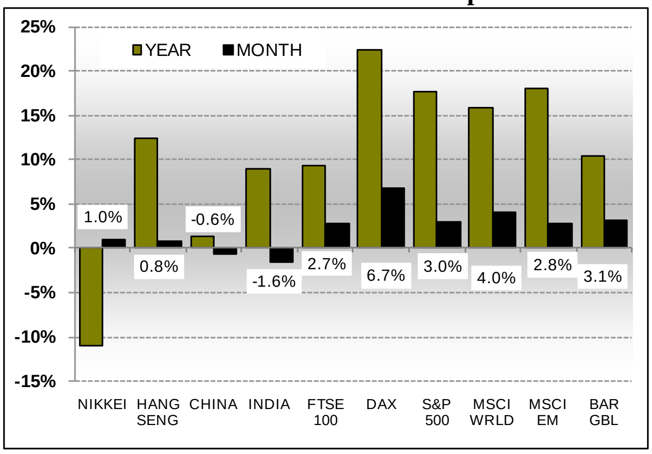
MAESTRO INTERMEZZO
11th Edition | May 2011

## April in perspective – global markets

If you think about it, this year has had more than its fair share of unusual variables and risk factors. If you need any reminding, you only need to re-read this year's editions of *Intermezzo* to refresh your memories. Well, April was no exception; it carried the baton of disruptions and surprises very well, yet the year-to-date returns of an internal set of indices we monitor reveal only three declines (the Japanese, Indian and Brazilian equity markets). Quite extraordinary! The feature of and most influential factor during April was the weak dollar (refer to the comments, below, by Merrill Lynch's economist about the US's credibility being chipped away slowing). A contributing factor to dollar weakness was the announcement by the S&P rating agency that it was changing its outlook on US debt from 'stable' to 'negative', implying there is a one-in-three chance of a downgrade to the current AAA sovereign debt rating. Nearly every currency firmed against the dollar: the euro rose 4.6%, sterling 4.1%, the Swiss franc 5.3% and the rand 2.6%. The weakness also had an effect on commodity prices; gold hit an all-time high of $1 568, rising 6.7%. Oil rose 7.3% (its annual gain is now 44.0%), silver rose to another record high, up a remarkable 28.6% and 161.6% for the month and year respectively. Base metals were firm and soft commodities, in particular the price of corn, also rose sharply. The CRB and S&P GSCI Commodity indices rose 3.1% and 5.6% respectively in April.

**Chart 1: Global market returns to 30 April 2011**




A less obvious effect of the weak dollar, fuelled by the prospects of very low US interest rates for a long time, was what we in the past have referred to as "the wall of money". With an effective zero interest rate in the US there is little incentive to retain any money in cash. The inexorable flow of capital into risk assets like equities (bonds are less attractive given the US sovereign debt risk) is, at least in our opinion, contributing to the relentless upward grind of equity markets this year. This is particularly true of developed markets; emerging markets are being tainted by rising interest rates and the fear of higher inflation (caused inter alia by the weak dollar). So, during April the MSCI World index rose 4.0%, bringing its year-to-date (ytd) return to 8.5% while the MSCI Emerging market index rose only 2.8% (4.6% ytd). The US equity market rose 3.0% (9.2% ytd), the UK 2.7% and Japan 1.0% (-3.7% ytd). Germany rose an astonishing 6.7% (8.7% ytd) on the back of robust corporate earnings and confidence in the strength of the German economy; remember that German business confidence is close to a 30-year high and unemployment is at a 30-year low. In the emerging market universe, Brazil *declined* 3.6% (-4.6% ytd), India 1.6%, Russia 0.8% and China 0.6% - for once all BRIC markets declined. The MSCI SA (dollar) index rose 4.8% and the All share index rose 4.9% in dollar terms. Even the global bond market posted a decent return this month; the Barcap Global Aggregate bond index rose 3.1% despite warnings about sovereign debt issues in the US and Eurozone.

**Photo 1: An Oxpecker and zebra**

Source: National Geographic

## What's on our radar screen?

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

- *The SA economy:* the annual rate of inflation rose to 4.1% in March from 3.7% in February. March is a high survey i.e. many items in the inflation basket are measured during March, which puts upward pressure on inflation for the month. The month-on-month inflation increase of 1.2% was the highest in two years. The month-on-month increase in food prices was 1.4%, bringing the annual rate to 5.1% from 3.5% in March. The annual rate of increase in retail sales slowed from 6.3% in January to 5.6% in February, while manufacturing production rose at an annual rate of 6.0% in February versus January's 1.6%. The country's gross reserves rose to $50.6bn in April and net reserves to $46.0bn.

- *The Chinese economy:* Chinese inflation rose from 4.9% in January to 5.0% in February, spurring the central bank to increase interest rates by 0.25% to 3.25%, its fourth increase since October. The authorities raised the banks' reserve requirement ratio yet again, by 0.5% to 20.5% - the tenth increase since the beginning of last year and the fourth one so far this year. The Chinese economy grew 9.7% in the first quarter to $1.46 trillion (tr) in size (versus the US's $14.7tr), down from 9.8% in the December quarter. Another "first" was registered by China when its foreign reserves rose above the $3tr for the first time in March, to $3.04tr. China finalised its 12th five-year plan for 2011 to 2015 last month. It identified three key objectives: a rising share of consumption (previous plans emphasized low-cost manufacturing), moving to a low-carbon economy and innovation. With respect to the latter, China plans to increase research and development spending from about 1.5% of GDP to between 2.0% and 2.25% by 2015. Its five-year plan highlights the importance of seven "magic" industries: energy-saving and environmental protection, next generation information technology, biotechnology, high-end manufacturing, new energy, new materials, and clear energy vehicles. It plans to raise the share of these sectors from the current 3.0% to 15.0% of the economy by 2105.

**Photo 2: Masked weaver**

Source: National Geographic

- *The UK economy:* initial estimates for Q1 economic growth in the UK came in at 0.5%, making up for the ground lost in the December quarter. Effectively that puts it back where it was at the end of September.
- *The US economy*: economic data emanating from the US economy was generally disappointing and pointed to a noticeable slow down, contrary to what the US equity market might have you believe. The US economy grew only 1.8% in Q1, down from 3.1% in Q4 last year. The Federal Reserve lowered it growth outlook for 2011 from between 3.4% and 3.9% to 3.1% and 3.3%. For the record, we still think that is a bit optimistic. Personal consumption expenditure (PCE) rose 2.7% in Q1, down from 4.0% in Q4.

**Chart of the month**

One of the most reliable indicators of economic health, which is often closely associated with the state of the equity market, is the slope of the yield curve. Any seasoned investment professional – let's define that as someone who can recall an office with no computers ☺ - will know that *the yield curve is an extraordinary accurate predictor of future economic activity*. There are a couple of definitions of a yield curve, but one of the most common is simply the yield (interest rate) on a 10-year bond less (minus) the yield on a 2-year bond. The historic relationship between these two yields is depicted in Chart 2.

**Chart 2: The US yield curve: what is it telling us?**

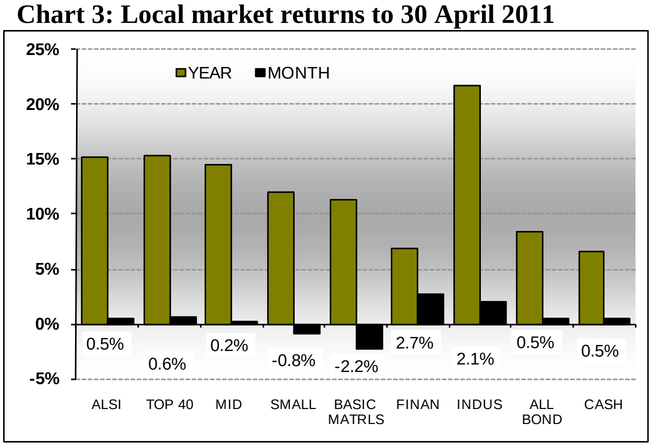

Source: Merrill Lynch

Think about it: if investors expect strong economic growth in the future it is reasonable to also expect higher interest rates in the future. So the longer term bonds, in this case the 10-year bond will start to anticipate a higher level of interest rates. The yield on the 10-year bond will thus rise more than the yield on a short-term bond. If you deduct the former from the latter over a period when such expectations prevail, the yield curve will be positive. In addition, the strength of the expectations will determine the *slope* of the yield curve. If economic growth is very strong, you would expect a very steep yield curve, such as the shape of the curve in late 2001 and into 2002 – refer to Chart 2 again. Ah, you say, but that's when the world went into a very short recession (exacerbated by the September 11 attacks). Correct, but remember that the yield curve *predicts* i.e. it is an indication of what is to come. Thus, in late 2001 and into 2002 the *bond* market - which on virtually any proper analysis is a more accurate indicator than the *equity* market – was predicting a strong economic recovery. That is exactly what happened. The strong growth between 2002 and 2007 sowed the seeds of destruction that occurred between 2007 and 2009 i.e. the Great Financial Crisis. And just look on Chart 2 how accurately the yield curve forecast that correction. So much so that by the beginning of 2007 (remember the Financial Crisis only started in July 2007) the yield curve was actually *negative* i.e. the yield on the short-term (2-year) bond exceeded the yield on the long-term (10-year) bond.

Now the yield curve is not infallible – no indicator ever is. But it is too accurate to ignore, which is why I am bringing it to your attention. Note where the yield curve is at the moment – around about 2.6% on 260 basis points (bps) to use industry jargon. At the time of writing the yield on the US 10-year bond was 3.14% and the 2-year yield was 0.54% (*Ed:* and yes, the yield on the 3-month bill was 0.0%!) Thus, 3.14% less 0.54% equals 2.6% or 260bps. Note, firstly, that it is positive, which is a healthy sign i.e. the market is not predicting any notable economic slowdown in the US. Secondly the current slope of the yield curve is quite steep, which is also indicative of reasonable economic growth into the future.

Of course, it is never so simple. We fully appreciate that with all the unconventional policies that have been applied around the world in the aftermath of the Financial Crisis, the EU sovereign debt crisis and the Japanese earthquake tragedy, the prevailing markets can hardly be regarded as normal. But the yield curve is such an established and accurate lead indicator (predictor) of economic activity, it would be foolish to ignore it. All of which is to say that the current shape of the yield curve provides us with a level of comfort, and is indicating that the level of economic activity is not about to come to a grinding halt.

**Chart 3: Local market returns to 30 April 2011**

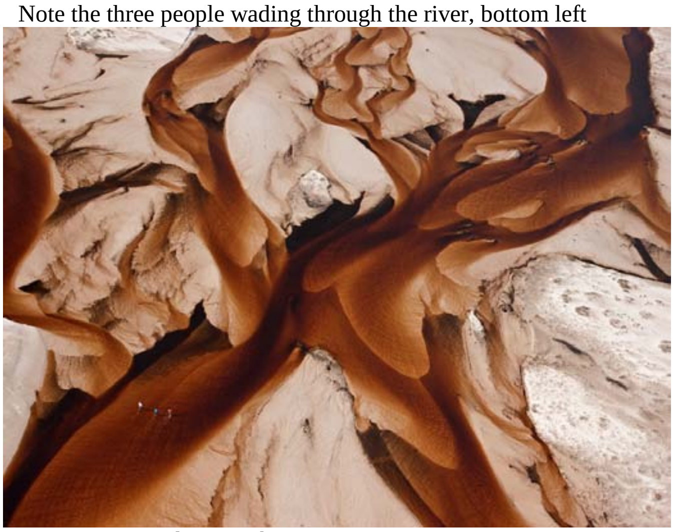



## April in perspective – local markets

Turning to the South African markets, as has been the case so far this year apart from January, the market ran into the headwind of a very strong rand. The latter rose 2.6% and put the brakes on many an index. Despite a record gold price, the gold index rose only 1% (3.1% ytd). The basic material index rose 0.5%, financials 2.9% and the industrial index 4.1%. All three major sectors are now up around 3.0% for the year-to-date. The All share index ended 2.2% higher; the large, mid and small cap indices rose 2.1% , 2.9% and 2.7% respectively – their respective year-to-date returns of 4.3%, -1.7% and -2.7% tell a different story though. The best performing sectors were media, up 8.4% (thanks to Naspers's 8.5% gain), electronic and electronic equipment 7.4% and coal 7.3% (thanks to Exxaro's 7.2% gain). The worst performing sector was oil and gas (Sasol fell 3.2%). The bond market had a good month; the All bond index rose 2.2% bringing its year-to-date return to 0.6%, less than the year-to-date return for cash of 1.9%.

**Photo 3: The River Negro in Brazil**

Note the three people wading through the river, bottom left



Source: National Geographic

## China: taking a closer look

As readers are aware, we spend a lot of time in *Intermezzo*, and in the Maestro office for that matter, monitoring the Chinese economy and its people. We will surely never experience anything quite like the phenomenon that China represents, in our lifetime again. Most times we are only afforded a high-level view; we don't spend too much time diving into the detail. However, this month we came across detail which I am sure will interest you.

In an effort to reduce the widening wealth gap - by some estimates the richest 1% of Chinese households control between 40% and 60% of household wealth - and to "spread the spoils" of recent economic growth, the Chinese authorities plan to lift the income threshold for personal tax payments. The level at which Chinese citizens must pay income tax is to be raised from Rmb2 000 ($305 or R2 050) to Rmb3 000 ($466 or R3 065) per month. This will reduce the number of individual taxpayers by 50m to 350m and will reduce government tax revenue by Rmb15bn. Last year Beijing collected a total of Rmb480bn in personal income tax, which accounted for 6.3% of total government revenue. Once government has implemented the new threshold, 94% of taxpayers will pay a tax rate of 10% or less on their

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income. In 2006 Beijing doubled the income tax threshold from Rmb800 per month to Rmb1 600 and then raised it again to Rmb2 000 in 2008.

Other measures include a promise to raise average wages by 15% a year, thus doubling the average wage by 2015. It also plans to build 35m low-income homes over the next five years. The government plans to lift its official poverty line from the current income level of $0.50 (R3.35) per day to $0.63 (R4.22) per day (about R125 pm) which will result in an increase in the number of people living in poverty from 27m to 100m, all of whom will be entitled to welfare assistance. The United Nations standard for *extreme poverty* is less than $1.25 per day and for the *relatively poor* is between $2 and $1.25. Thus, by the UN's standard about 254m Chinese or one in five still live in extreme poverty.

**Photo 3: A little owl (*Athene noctua) in Spain***

Source: National Geographic

**A few quotes to chew on**

"After a recent rally across world markets, many of our clients have called asking me to "remind them" once again how a tragic nuclear accident, earthquakes and a tsunami in Japan, regime change in North Africa, a war in Libya, and $120 oil can really be good for equity markets. Yes, we understand that equities like to climb a 'wall of fear', but surely..." *Guy Monson, Chief Investment Officer, Sarasin & Partners.*

"In the movie 'Rebel Without a Cause' defiant teenagers play a game of 'chicken', driving their cars at full speed towards a cliff to see who has the courage to jump out last. Tragically, one driver is stuck in his car and flies over the cliff. Today, Congress seems to be considering a remake of this movie classic. The near-shutdown of the government on April 8 was a rehearsal for a much more dangerous game. In this first game of chicken, the stakes were low: closing national parks, delaying passports, etc were never a serious threat to the economy or the markets. By contrast, playing chicken with the debt ceiling is a very dangerous game." *Ethan Harris, Merrill Lynch North American Economist.*

"Until recently we were convinced that the US was at least several years of bad policy away from a debt crisis. After all, the Treasury (bond) market continues to perform well. The US caused the global crisis and yet at the height of the crisis money poured into the US treasury market. When the Greek crisis erupted, investors ran away from one high-debt country (Greece) into another (the US). And most recently, the bond market shrugged off the nasty budget debate and a credit warning from S&P. Unfortunately, credibility is slowly chipped away. *The US is the only high-deficit country in the world that does not have a serious austerity plan in the works* (my italics). The Budget proposals for 2012 are miles apart. And brinkmanship around the debt ceiling could offer a regular reminder to investors of the untenable path of US fiscal policy. Deficit hawks are justifiably frustrated by the lack of progress on the deficit, but as my mom says, 'two wrongs don't make a right'. Ironically the debt ceiling brinkmanship may end up adding to, rather than reducing, the deficit. If investors begin to lose faith in the creditworthiness of the US government, debt service (costs) will rise. With $10 trillion of publicly-held debt, a one percentage point rise in borrowing costs adds $100bn to the deficit... Similarly, if the debt ceiling debate undercuts confidence in the economy, it undercuts growth and tax revenues." *Ethan Harris, Merrill Lynch North American Economist.*

"Tim Geithner wants a strong dollar. Ben Bernanke wants a strong dollar. For all we know, Kate Middleton is rooting for the greenback. But what the US Treasury secretary and the Chairman of the Federal Reserve say they desire is not matched by their actions and they have got a weak dollar. Weak, weaker, weakest. The Fed's own measure of the dollar in real terms against America's main trading partners shows it ended March at its lowest level since it first traded freely in 1973. Since then it has fallen further as Mr Bernanke's (recent) supportive comments, far from shoring up the greenback, accelerated its decline. " *James Mackintosh, Financial Times.*

There was a lot of response to the change by the S&P rating agency in the outlook for the US credit rating. The two most notable were from the largest holders of US debt, China and the Japan. Japan played down concerns about US credibility, but *the Chinese government* had the following to say; "We hope the US government will take responsible policies and measures to safeguard investors' interest". China should be concerned; although the actual total is not disclosed, it is estimated that about two thirds i.e. about $2 trillion dollars of Chinese reserves are held in US assets.

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According to US data China holds $1.2tr in treasuries (bonds) while Japan holds $890bn. China repeatedly calls on Washington not to intentionally debase the dollar and to protect the interests of foreign investors in its bonds.

Commenting on the US debt disaster *Financial Times commentator Clive Cook* had the following to say; "(President Obama) calls for large deficits long after the economy has returned to full employment, and an indefinitely rising ratio of public debt to gross domestic product. It has come to something when the White House makes eventual fiscal collapse official policy. That is novel even in Washington."

"The US lacks a credible strategy to stabilize its mounting public debt, posing a small but significant risk of a new global economic crisis. It is a risk that, if it materialises, would have very important consequences ... for the rest of the world. It is important that the US undertakes fiscal adjustment in a way sooner rather than later." *Carlo Cottarelli, head of fiscal affairs at the International Monetary Fund.*

**For the record**
Table 1 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. Fund Summaries for each respective fund listed in the table are available on our website.

**Table 1: The returns of funds under Maestro's care**

| | Period ended | Month | Year to date | Year |
|---|---|---|---|---|
| **Maestro Equity Fund** | **Apr** | **2.9%** | **-2.7%** | **11.5%** |
| *Maestro equity benchmark ** | *Apr* | *3.0%* | *4.9%* | *19.6%* |
| *JSE All Share Index* | *Apr* | *2.2%* | *3.4%* | *17.8%* |
| **Retirement Funds** | | | | |
| **Maestro Growth Fund** | **Apr** | **2.1%** | **-2.3%** | **8.6%** |
| *Fund Benchmark* | *Apr* | *1.8%* | *2.9%* | *13.3%* |
| **Maestro Balanced Fund** | **Apr** | **1.9%** | **-1.5%** | **7.9%** |
| *Fund Benchmark* | *Apr* | *1.6%* | *2.7%* | *12.2%* |
| **Maestro Cautious Fund** | **Apr** | **1.7%** | **-1.6%** | **9.2%** |
| *Fund Benchmark* | *Apr* | *1.5%* | *2.0%* | *10.9%* |
| **Central Park Global Balanced Fund ($)** | **Mar** | **0.4%** | **0.5%** | **8.4%** |
| *Benchmark*** | *Mar* | *-0.3%* | *2.4%* | *8.0%* |
| *Sector average **** | *Mar* | *-0.1%* | *2.2%* | *9.3%* |

* 50% JSE Top 40 Index, 50% JSE Financial & Industrial 30 Index
** 40% MSCI World Index, 20% each in Barclays US Aggregate Bond Index, Credit Suisse Tremont Hedge Index and 3-month US Treasury Bills
*** Lipper Global Mixed Asset Balanced sector ($)

**File 13: Information almost worth remembering**
*Some clangers from the real world...*
Sometimes we come across remarkable comments or statements that defy logic or make one wonder if you are seeing things. This month, we came across some classics! Firstly, we came across this media release off a website no less "authoritative" than the US Federal Reserve. If you ever wondered how the US in general and US consumers in particular got themselves into their current mess, wonder no more. The media release reads as follows. "The Federal Reserve Board on Tuesday requested public comment on a proposed rule under Regulation Z that would require creditors to determine a consumer's ability to repay a mortgage before making the loan and would establish minimum mortgage underwriting standards". I kid you not! One wonders why they never began establishing critical criteria like this about 200 years ago, let alone prior to the sub-prime mess! In case you don't believe me – I could hardly believe it myself when I saw it for the first time - you can visit the release for yourself by clicking here.

Secondly, after the S&P credit rating agency changed their outlook on US sovereign debt to "negative", the first utterance was, not surprisingly, from the US Treasury (Department of Finance in SA parlance). Mary Miller, assistant Treasury secretary for financial markets had the follow to say. "S&P's negative outlook underestimates the ability of America's leaders to come together to address the difficult fiscal challenges facing the nation". Say what?! This is a bit rich from an Administration that is about six months into its fiscal year and has yet to sort out a Budget. For politicians who can't agree on last year's budget or the current one, it is hard to believe they will get future one's right, too. You really can't blame us for distrusting politicians – they are typically "strangers from the truth".

*And you thought you had problems?!*
I do not mean to belittle Japan or its people, or obtain mileage out of last month's tragedy, but when I came across these pictures I just had to share them...


Source: www.marinetraffic.com

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I have a very simple question: where do you start when tasked with the job of putting this ship back where it belongs? Just imagine the power of the water to lift this 175 000 tonne ship, like driftwood, onto the quay in the port of Kamaishi, north-eastern Japan. And you think you have bad days in the office!


Source: [www.marinetraffic.com](www.marinetraffic.com)

*It's a small world*
It is fun looking at all the heavy equipment in the mines and shipping industry, for example, when doing analysis. For example, shipping giant AP Moller Maersk recently placed a $6bn order for a few ships that will be the largest to ever take to the seas. They will be capable of carrying 18 000 containers at once. To put that into perspective, if you had to put that many containers on a train, it would be 110km in length!

But we should not forget that, at the other end of the size scale, the world of "tiny objects" is also breaking new ground. We came across two such examples during the past month. Firstly, we heard of the latest innovations in the microchip and processor worlds. Made in a machine about the size of a photo booth (but at $45m costs the same as a Boeing 737!) ASML's latest machine is capable of manufacturing a transistor that is 22 nanometres (nm) in size. To put that in perspective, a human hair grows at 4nm per second, meaning it would take 5 seconds for a hair to grow across this transistor. By the way, a nanometre is one billionth of a meter.

The other bit of useless (but jolly interesting!) piece of information is that last week Intel announced a new design for their transistor. Whereas the earlier 2D design was 32nm in size, the new 3D tri-gate transistor is only 22nm in size. Once again, putting that into perspective, more than 6m (that's six million!) of them would fit in the full stop at the end of this sentence. Oh, and by the way, the old transistor was capable of switching the electron flow on and off up to 100bn (that's one hundred billion) times *per second* – the new transistor can improve on that performance by 37% - using only half the power. So let us continue to enjoy our computers, cellphones, iPads, etc, blissfully unaware of how hard these little "fella's" are working to make it all happen ☺.

**Table 2: MSCI returns to 30 April 2011 (%)**

| | Apr'11 | YTD | Q1'11 |
|---|---|---|---|
| Hungary | 11.9 | 34.4 | 20.2 |
| Poland | 10.5 | 18.1 | 6.9 |
| Czech | 9.8 | 27.7 | 16.3 |
| Turkey | 9.3 | 3.3 | -5.5 |
| Chile | 9.0 | 0.0 | -8.3 |
| Taiwan | 6.6 | 2.1 | -4.2 |
| Korea | 6.5 | 13.4 | 6.5 |
| Philippines | 5.8 | 1.1 | -4.4 |
| Australia | 5.8 | 9.2 | 3.2 |
| Thailand | 5.6 | 9.2 | 3.5 |
| Indonesia | 5.0 | 9.8 | 4.7 |
| Singapore | 4.9 | 4.1 | -0.7 |
| South Africa | 4.8 | 1.9 | -2.8 |
| Colombia | 4.2 | 4.2 | 0.0 |
| **AP ex Japan** | **4.2** | **5.7** | **1.5** |
| **MSCI DM** | **4.0** | **8.5** | **4.3** |
| **EMEA** | **3.9** | **8.7** | **4.7** |
| **EM Asia** | **3.6** | **4.9** | **1.3** |
| Pakistan | 3.1 | 2.5 | -0.6 |
| **MSCI EM** | **2.8** | **4.6** | **1.7** |
| Hong Kong | 2.3 | 1.5 | -0.8 |
| Malaysia | 1.6 | 5.3 | 3.6 |
| Mexico | 1.3 | 1.8 | 0.5 |
| China | 1.3 | 4.2 | 2.9 |
| Japan | 0.4 | -5.5 | -5.9 |
| Russia | 0.2 | 16.6 | 16.3 |
| **LatAm** | **0.0** | **0.4** | **0.4** |
| Morocco | -0.7 | 4.7 | 5.5 |
| India | -1.1 | -6.2 | -5.2 |
| Brazil | -1.1 | 0.8 | 2.0 |
| Israel | -3.1 | -5.9 | -2.9 |
| Argentina | -3.3 | -14.9 | -12.0 |
| Peru | -5.9 | -19.1 | -14.0 |
| Egypt | -8.1 | -29.9 | -23.7 |

Source: Merrill Lynch

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