INTERMEZZO

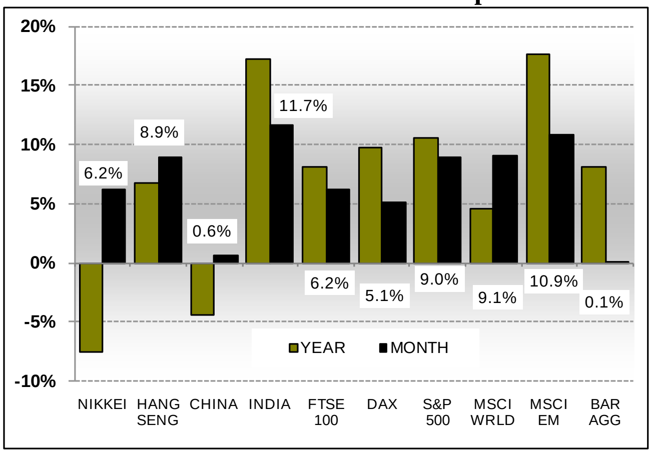
MAESTRO

Investment Letter | 10th Edition | October 2010

September in perspective – global markets

As we say in South Africa, "Eish!" What else can one say after the greatest September rally in the US equity market since 1939? Well, you could begin by acknowledging that the 9.0% US equity rally was profound but not the most profitable market in the month. There was the 11.7% rally in India, the 13.6% monthly gain in Indonesia, not to speak of the 15.0% dollar return of the SA equity market. And then there were the conundrums; why did one of the fastest growing economies, China, only rise 0.6%; or why, when there is no inflation in sight in most countries around the world, did gold finish the month at a 30-year record price of $1 310; why do US retail investors continue to pour money in to the bond market, which currently yields around 2.5% with no capital growth, but are eschewing investment in companies with 5% and 6% dividend yields? Such are the contradictions inherent in the current pricing of investment markets. With the US fiscal deficit seemingly out of control and very little growth to speak of, perhaps we should not be surprised that the dollar continued its downward trend in September; it declined 6.9% against the euro, 2.4% against sterling and 5.4% against the rand. In the process it contributed to large price increases in the commodity complex. Copper rose 9.4%, platinum 9.7%, oil 10.3%, nickel 12.1%, palladium 16.0% and silver 17.0%. In light of these increases, the 4.9% gold price rise (on the back of a 6.9% decline in the dollar euro rate) looks puny despite all the airtime the gold price receives. Bond market investors managed to eke out positive gains – the Barcap US Aggregate bond index rose 0.1%.

Chart 1: Global market returns to 30 September 2010



What's on our radar screen?

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

- *The SA economy:* a big news item on the SA front in September was the reduction in interest rates. The repo rate was cut by 0.5% to 6.0%, its lowest level in 30 years. At the same time as their rates decision, the SA Reserve Bank (SARB) reduced its inflation forecast to 4.8% in 2011 and 5.1% in 2012. It also reduced its SA growth forecast to 2.8% in 2010 (previously 2.9%) and 3.2% in 2011 (from 3.6%). As if on cue inflation in September declined from 3.7% to 3.4%. With the release of SARB's second quarter (Q2) Quarterly Bulletin, SA's current account deficit was shown to be 2.5% of GDP, lower-than-expected, from Q1's 4.6%, thanks in part to foreign tourist receipts surrounding the World Cup. This benefit is a once-off, and will not be repeated: the deficit is likely to head back towards 4.0% in the coming quarters.
- *The US economy*: we won't dwell on the raft of US data released during the month. Suffice is to say that, unlike in August when it was uniformly worse than expected, September's data was generally better than expected. This encouraged equity markets as did the Fed signalling that it was ready to implement another round of quantitative easing –so-called "QE2" (any association with the Titanic in this regard is purely coincidental, of course). We note that a large degree of divergent opinion exists regarding the future of the US economy – refer to Table 1. These are all respectable names, particularly that of the Fed, but only one can be right. The Fed's forecasts look way out of line, raising the prospect that sooner or later the Fed will lower its growth rate for the US economy (*Ed:* I don't suppose it's politically correct to do so just ahead of an election though). That probably won't go down too well in an equity market that has just risen by 10%.

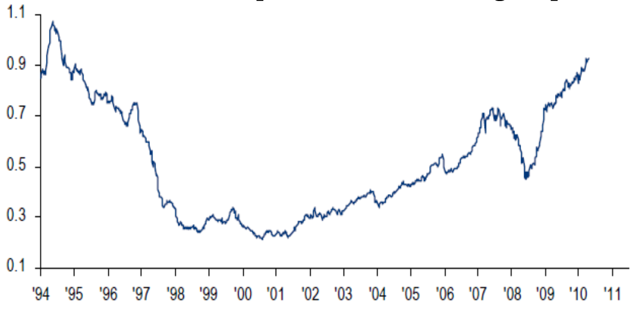
Table 1: Selected US economic projections (%)

	GDP growth		Unemployment	
	2010	2011	2010	2011
Federal Reserve	3.0 - 3.5	3.5 - 4.2	9.2 - 9.5	8.3 - 8.7
Merrill Lynch	2.6	1.8	9.8	10.1
Deutsche Bank	2.8	3.1	N/A	N/A
Consensus	2.7	2.5	9.6	9.0

Chart of the month

In the latest *Market Commentary*, published in September, we included an article written by Luke Sparks on *The case for investment in mid and small cap equities*. In that article we included a comparison of the SA and US experience, and noted that mid and small caps tend to outperform their large cap counterparts in all areas of the world i.e. the phenomenon is not isolated to any particular country. With that by way of background, Chart 2 is informative: it shows emerging market (EM) small cap performance relative to large cap shares in developed markets (DM), in dollar terms. Not only are small caps continuing their remarkable outperformance since 2000 but they are now close to their relative levels of 1994. The message remains unequivocal: small cap shares (and mid caps for that matter) in emerging markets, including SA, remain in demand and are performing better than large cap shares.

Chart 2: EM small caps relative to DM large caps

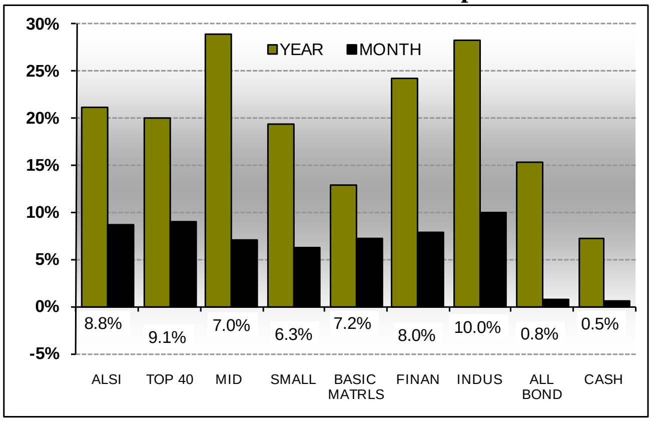


Source: Merrill Lynch

September in perspective – local markets

Returns from the SA equity market were not as dramatic as their offshore peers. In dollar terms though, at 15.0% they were nothing short of spectacular. It was to be expected that the 5.8% gain of the rand against the dollar would retard returns of the large resources companies. The basic materials index rose "only" 7.2% versus the respective gains of 8.0% and 10.0% of the financial and industrial indices. It is worth highlighting that the year-to-date return of the basic materials index is -3.5%, in stark contrast to the financial (16.7%) and industrial (18.2%) index returns. Despite September's underperformance by mining companies, the large cap return of 9.1% exceeded the mid (7.0%) and small (6.3%) cap returns this month, thanks in part to robust returns from large financial and industrial companies such as Richemont (19.5%) and Naspers (14.5%). The best performing sectors during the month included personal goods (Richemont) up 20.5%, general retailers 16.9% and media (Naspers) 14.8%. The All bond index was subdued, rising only 0.8%, but bear in mind that bonds have risen sharply (14.1%) this year already.

Chart 3: Local market returns to 30 September 2010

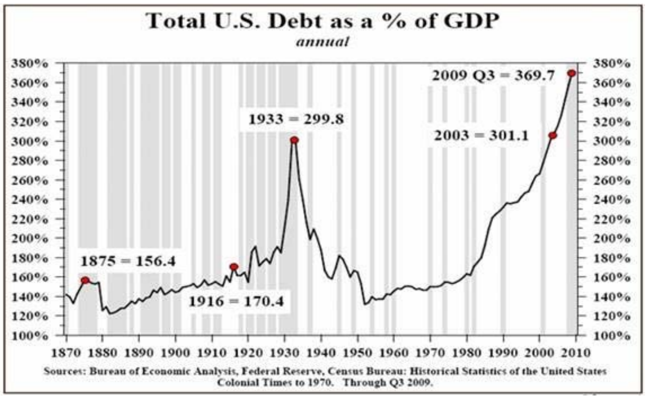


A few quotes to chew on

There really are two Americas, but they are not captured by the standard "class warfare" speeches that dramatize the gulf between the rich and the poor. Of the new divisions, one is the gap between employed and unemployed ... Another is between workers in the private and public sectors. No guesses which are the more protected. A recent study by the Mayo Research Institute found that "private-sector workers were nearly three times more likely to be jobless than public-sector workers". Political tension is bound to grow when jobs disappear faster in the private than the public sector, just as compensation in the former is squeezed more. There was a time when government work offered lower salaries than comparable jobs in the private sector, a difference for which the public sector compensated by providing more security and better benefits. No longer. These days government employees are better off in almost every area: pay, benefits, time off and security, on top of working fewer hours. Public workers have become a privileged class – an elite who live better than their private-sector counterparts. Public servants have become the public's masters. Take federal employees. For nine years in a row, they have been awarded bigger average pay and benefit increases than private-sector workers. In 2008, the average wage for 1.9m federal civilian workers was more than $79,000, against an average of about $50,000 for the nation's 108m private-sector workers, measured in full-time equivalents. Ninety per cent of government employees receive lifetime pension benefits versus 18 per cent of private employees. Public service employees continue to gain annual salary increases; they retire earlier with instant, guaranteed benefits paid for with the taxes of those very same private-sector workers. *Mort Zuckerman, editor in chief of US News & World Report and chairman and co-founder of Boston Properties*

The following comment falls into the chapter "So some people really do get it". With all the noise emanating out of the US about the relative value of China's currency, the yuan, we have been blessed with some real pearls of wisdom from US policy makers. In a recent testimony by US Treasury Secretary Geithner, the US Senate Banking committee chairman Christopher Dodd had the following to say. "China basically does whatever it wants while we grow weaker and they grow stronger."

The following is an extract from well-known *author of the Frontline Weekly newsletter, John Mauldin's July17 article, The Debt Supercycle*. It goes to the heart of one of our largest concerns right now, namely the extent of debt in the US. Under the heading "Path to Profligacy" he had the following to say: "How did we get here? We simply kept borrowing ever greater amounts of money at an increasingly rapid pace. Look at the chart below. It is about six months old, but not much has changed. In the beginning, each dollar of debt brought about a corresponding dollar of increase in GDP. But that early money was invested in houses and in the means of production, which helped grow the economy. As time went on, and especially after the '80s, more and more of the debt was used for consumption (of which much has come to be from foreign sources) and not for the increase of productive capacity. Toward the end, it took $3 of debt to create a $1 rise in GDP in the US. And now, each $1 rise in debt is government debt, which some research ... says has a slightly negative multiplier - it actually hurts GDP."



John Mauldin continues with the following telling comments: "So, can we know how The End Game will turn out? The short answer is no. Each country will have to make its own political choices. Could we see hyperinflation in the US on Britain or Japan? It is possible, with bad policy decisions. I doubt it that it gets to that. But could we see inflation? The answer is yes. That has been the traditional method of default for many countries over the years. Instead of outright default, they simply inflate away debt. And the logic is compelling. If you have 5% inflation along with 3% real growth, you get a nominal growth rate of 8%. That means in nine years the economy is twice the size in dollar terms, but only about 35% bigger in inflation-adjusted terms. If somewhere along the way you can get your deficits down to "just" 3%, then you can reduce your debt-to-GDP ratio by 5% a year. In less than ten years, you cut your debt-to-GDP ratio in half. Sounds good, right?

Of course, you have destroyed the purchasing power of your currency, given a real hit to the incomes of the middle class, defrauded those who bought your debt, and in all likelihood you did not hold inflation to just 5%. Think the '70s."

A couple of thoughts on the global bond market

As we have brought to your attention a few times in our Quarterly Reports and *Market Commentaries*, global bond markets have generally been firm this year while equities have been the laggard - the comparative returns would look a lot worse was it not for the extremely robust equity markets in September. During the nine months to end-September i.e. the year-to-date, the global bond market has produced a return of 7.8% versus the global equity market return of 0.9% despite the massive September rally. In South Africa the respective returns are 14.1% and 8.7% (to end-August they were 13.3% and -0.1% respectively). Many market watchers have looked on in amazement as bond yields in the US in particular have header lower (i.e. prices have headed higher) despite the concerns about the over-indebtedness of the US. Table 2 shows a selection of 10-year sovereign yields.

Table 2: 10-year sovereign bond yields - 30 Sept 2010 (%)

Developed countries		Emerging countries	
Germany	2.29	China	3.01
Japan	0.94	India	8.14
US	2.52	Indonesia	3.91
UK	2.95	Malaysia	2.64
Ireland	6.74	Brazil	6.16
Portugal	6.38	South Africa	7.70
Greece	10.56	South Korea	4.04
Australia	4.78	Turkey	4.03
Singapore	1.89	Russia	5.34
Spain	4.41	Taiwan	1.04
France	2.69	Thailand	2.76

Source: Financial Times, Economist

This strong bond market in the US has prompted questions about how much further bond yields can decline. We tried to answer this question in our *Market Commentary*, where we spent some time on the *Japanification* of the US i.e. the possibility that the US might follow the course of Japan into a multi-year period of slow growth and deflation. Chart 4 provides an historic perspective on the yield of the US long-term bond.

Chart 4: US Treasury long-term bond yield (%)

Source: Gluskin Sheff

What has intrigued us, as it has many other investment managers, is why investors would buy a 10-year bond from a government whose balance sheet is in tatters and faces huge deficits for many years into the future and accept a return of only 2.5% for the next ten years, when the alternative is to buy the equity of a quality global company, whose balance sheet is very strong (and getting stronger) in return for a dividend yield of 5% or 6%. Of course there is a difference in the underlying risk, but after ten years you will only get your capital back from the bond investment while there is every chance your capital would have increased substantially over the ten-year period if you buy the share.

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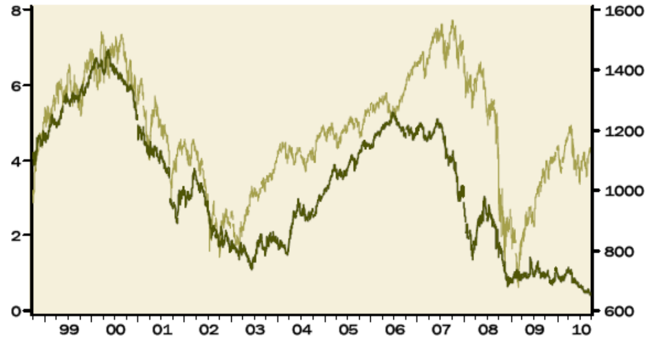
Such are the anomalies being thrown in front of investors in a world flooded by cheap government money and where the tolerance for risk remains very low.

Chart 5: US 2-year bond yield and the US equity market
2-year yield (%) – black thick line, right hand scale



Source: Gluskin Sheff

Chart 5 sums this up very nicely. It depicts the yield of the US 2-year bond and the S&P500 (the US equity market). As our friend Dave Rosenberg points out, there is a 75% positive correlation between the two indicators; given that the 2-year yield is close to record low while the US equity market moves higher and higher, it is clear one of them is wrong. They cannot both be right; something has to give. History shows that the bond market is usually right – watch this space.

Spotlight on Brazil
Although we are very conscious of it, we don't spend enough time commenting on events in Brazil in *Intermezzo*. But there are a few reasons to do so this month. Firstly Brazil has just set the record for the largest share issue ever undertaken on financial markets. Its national petroleum company, Petrobras, raised $67bn in late September as part of their efforts to bolster the company's resources as it gears up to develop what are believed to be one of the largest untapped oil reserves in the world, the so-called pre-salt reserves just off Brazil. Although the government will receive about $42bn of the issue, in payment for the rights to 5bn barrels of oil, the issue remains astonishing in its proportions. Total demand from existing shareholders and new investors was $87bn. Speaking after the closing of the successful record share issue President Luiz Inácio Lula da Silva's words were poignant; "It wasn't in Frankfurt. It wasn't in London. It wasn't in New York. It was here in São Paulo!"

At the time of writing Brazil is going to the polls to elect a new president as outgoing President Lula da Silva's second term comes to an end. Apart from their slow but steady progress into a global powerhouse, Brazil is preparing for not one but two global sporting events. Having just hosted the Fifa World Cup Soccer final, South Africans will appreciate what the following means: in 2014 Brazil will host the next World Cup Soccer final and then only two years later will host the 2016 Olympic Games. I guess it is fair to say that Brazil is likely to remain in a festive mood for a long time to come.

For the record
Table 3 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 3: Returns of funds under Maestro's care

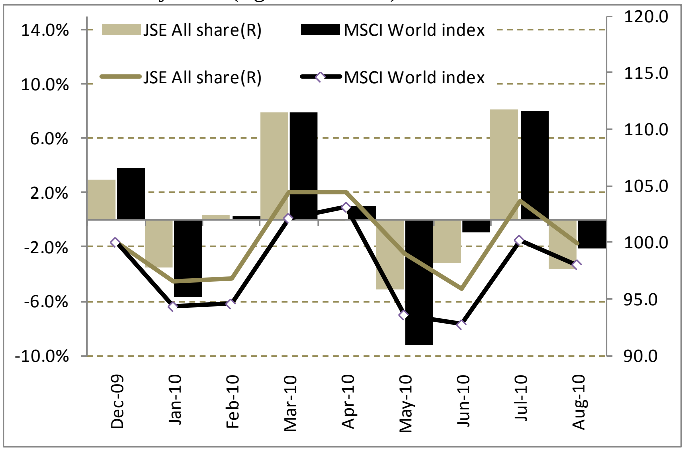
	Period ended	Month	Year to date	Year
Maestro Equity Fund	Sept	**8.3%**	**6.8%**	**9.1%**
Maestro equity benchmark *	Sept	9.5%	11.5%	23.3%
JSE All Share Index	Sept	8.8%	8.7%	21.1%
Maestro Long Short Equity Fund	Aug	**-1.9%**	**-1.4%**	**1.5%**
JSE All Share Index	Aug	-3.1%	-0.1%	11.6%
JSE Financial and Indus 30 index	Aug	-2.2%	6.0%	15.0%
Central Park Global Balanced Fund ($)	Aug	**-3.8%**	**-7.2%**	**-3.7%**
Benchmark**	Aug	-1.3%	-0.9%	3.7%
Sector average ***	Aug	-1.6%	-2.2%	2.7%

* 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 ($)

Up, down, up, down, up, down ...
In past correspondence with clients and friends of the company I have often commented that the past year has felt as though we are running flat out and getting nowhere. Of course this is not exactly true; *annual* (to end-September) equity returns have been positive but, prior to the bumper September returns, the *year-to-date* returns were virtually flat. Those who follow markets closely will be familiar with the volatility of monthly returns so far this year but it is worth taking another look in any event. The monthly returns during the year-to-date ended *August* (not September) of the local and global equity markets are shown in Chart 6. Two aspects are immediately evident: firstly, like a flock of ostriches whose heads keep bopping up and down the returns have been anything but consistent i.e. they have been very volatile. Secondly, the extent of the monthly returns has been large by any standards, especially on global markets. During the first eight months of this year global monthly returns have exceeded 5.0% in absolute terms half of the time (on 4 of the 8 occasions), twice being negative and twice positive. And for all the volatility, local equity investors have been rewarded with no return (-0.06% to be

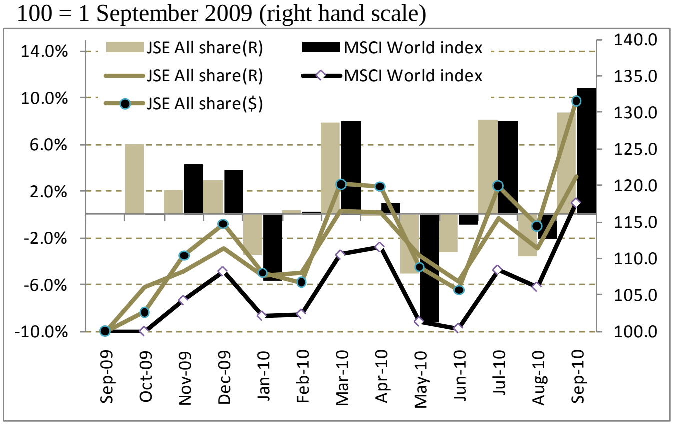
exact – refer to the green line) while global equity investors are worse off (-0.45% - black line with a white dot). It is no wonder investors feel like they are running flat out and getting nowhere?!

Chart 6: Monthly equity returns: January to August
100 = 1 January 2010 (right hand scale)



But let's expand the period to include September, which as you have seen brought with it excellent and extraordinarily high returns, and we include the fourth quarter of 2009 so that we extend the period to the past year. The results are shown in Chart 7. The past year now includes monthly global equity returns that have exceeded 5.0% in absolute terms more than half the time (on 5 of the 9 occasions), twice being negative and three times positive.

Chart 7: Monthly equity returns: 12-months to end-Sept
100 = 1 September 2009 (right hand scale)



Despite the strong rand local and global equity markets have moved in step, which is not that surprising on the face of it (note that on the chart below I have added the All share returns in dollars [the black line with the blue dot]). On six occasions during the past year the returns were very different (October, November, January, May, June and August) yet the cumulative returns in local currency terms are quite similar (21.1% versus 17.7%); in dollar terms there is more of a difference (31.6% versus 17.7%). In short, it is still not surprising that we are "tired of running flat out" but at least after September we now have something to show for it. Let's hope it stays that way through to the end of the year!

State of the nation – another opportunity at Maestro

An opportunity has arisen within Maestro for a person seeking a career in investment management. Although we have called the role one of Investment Administrator the opportunity is far greater. We are looking for someone to assist us in the "back office" initially, but depending on the attributes of the chosen candidate, our intention would, over time, guide them towards becoming what we call a "consummate investment professional". Luke Sparks is responsible for the Administration at Maestro at the moment but we would like him, over time, to train someone up for this role. The incumbent would, ideally, have a university qualification, and preference will be given to a bilingual female. If you know of anyone interested or suitable in this position, please let Luke (luke@maestroinvestment.co.za) know and he will send them a detailed Job Description.

File 13: Information almost worth remembering

For the benefit of our relatively new readers, let me remind you that in the "File 13" section we take a look at the more unbelievable (but nevertheless always true), bizarre events around the world, only some of which are investment-related. It is the section where we either try and bring a smile to your face or present you with something so incredulous it is hard to believe.

The following is a case in point: just when you thought most people in the world have woken up to the "new normal" i.e. the fact that the global economy has changed for the worse and is now characterized by frugality in most parts of the world, comes the story of a new "water extravaganza", the House of Dancing Water at the City of Dreams entertainment complex in Macau. The City of Dreams is run by Melco Crown Entertainment, one of Macau's large casino operators.

Source: www.news.cn

For the record Macau overtook Las Vegas as the world's largest casino market by revenue in 2006. The new show took five years to plan and performers have been in training for the past two years. Why do I bring this to your attention? Well, the cost of the production was no less than $250m and its opening weekend on 17 September was a complete sell-out. I guess no one told the Chinese that the Western world is in or close to a recession.

On to something a bit more economic in nature (some would argue a bit closer to home); the financial media were full of stories about the nationalization of certain companies in Venezuela in 2008 but subsequent events have been less well covered. The state of the Venezuelan economy is there for all to see – it doesn't look too pretty right now with GDP "growth" of -5.5% and inflation above 30% – but I found the following story intriguing. In 2008 Venezuela nationalised a large part of the construction industry, including local subsidiaries of foreign cement companies, on the basis that "insufficient homes were being build" (*Ed*: yeah, right). Swiss-based Holcim, the world's second largest cement company, disagreed with the government on the valuation they were forced to accept and subsequently took the government to the International Centre for Settlement of Investment Disputes. Before the outcome of the arbitration was finalised, the two parties reached agreement that the total compensation for Holcim's nationalised company would be finalised at $650m. The operation had annual sales of $200m. Earlier, the Venezuelan government agreed, after considerable delay, to compensate Lafarge, the largest cement company in the world, $250m for their nationalised subsidiary. Perhaps not surprisingly, whereas the country was an exporter of cement until two years ago, since nationalization the industry has floundered and the country now imports cement to meet its requirements.


Source: National Geographic

With a little space in hand, I share with you a photograph I stumbled across recently (bottom, left). Most investors have heard of a "Black Swan" phenomenon – some more than others - but this beautiful photograph redefines the concept a bit, doesn't it?

Table 4: MSCI returns to 30 September 2010 (%)

	Q3'10	Sep'10	YTD
Argentina	40.8	16.4	35.4
Poland	34.8	17.2	8.6
Chile	32.4	10.3	34.4
Turkey	31.9	15.3	28.5
Colombia	31.7	6.9	49.2
Thailand	30.9	13.5	42.6
Philippines	28.1	19.3	35.4
Hungary	27.0	16.4	-1.4
Peru	24.4	11.0	28.0
South Africa	24.2	13.9	16.1
Australia	22.0	13.1	1.0
EMEA	**21.1**	**11.1**	**9.9**
Hong Kong	21.1	13.6	14.7
Brazil	21.0	10.4	1.1
LatAm	**20.4**	**10.4**	**6.4**
EM Europe	**19.7**	**9.5**	**5.6**
Malaysia	17.6	5.2	26.9
MSCI EM	**17.2**	**10.9**	**8.7**
AP ex Japan	**17.0**	**11.6**	**7.3**
Korea	17.0	11.9	11.1
Indonesia	16.7	14.0	32.6
Taiwan	15.7	10.7	0.8
Czech	15.3	6.5	-4.1
India	15.0	16.2	17.1
Singapore	14.7	7.9	11.5
EM Asia	**14.7**	**11.0**	**9.1**
MSCI DM	**13.2**	**9.1**	**0.9**
Russia	13.1	5.8	0.6
Mexico	11.2	10.8	8.4
China	10.1	8.5	1.6
Egypt	10.0	2.7	4.3
Morocco	7.9	7.7	6.6
Pakistan	0.1	-1.4	-1.0

Source Merrill Lynch