MAESTRO
Cautious Fund

PRESCIENT
LIFE LIMITED

INVESTMENT OBJECTIVE
The Fund is balanced across multiple asset classes, subject to the restrictions imposed by Regulation 28 of the Pensions Funds Act. It aims to minimise the probability of short-term (i.e. less than one year) capital loss. A conservative investment philosophy is adopted.

FUND BENCHMARK (BMK)
The Fund will measure itself against a benchmark consisting of 30% All share Index, 30% All bond Index (ALBI) and 40% Short term fixed income (STEFI) index.

LEGAL STRUCTURE
The Fund is a pooled portfolio on the Prescient Life Limited balance sheet. The appointed portfolio manager of the Fund is Maestro Investment Management (Pty) Limited, an approved Financial Services Provider in terms of the Financial Advisory and Intermediary Services Act, operating under licence number 739. Prescient Life Limited is a linked insurer governed by the Long Term Insurance Act. Prescient Life Limited issues investment linked policies. This Fund operates as a white label under the Prescient Life Licence.

FEE STRUCTURE
The annual investment management fee is 1.0%. The fee is inclusive of all underlying managers' fees, platform and administrative fees. In the case where the Fund is accessed and used as a Preservation Fund or Retirement Annuity an additional fee of 0.2% per annum is charged by Prescient.

FUND SIZE: R1 446 170

LONG TERM INSURER
Prescient Life Limited
(Reg no: 2004/014436/06)

AUDITOR
KPMG Inc.

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd
(Reg no: 2000/028796/07)

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The Maestro Cautious Fund

Quarterly report for the period ended

30 June 2014

1. Introduction

This Report focuses on the investment activities of the Maestro Cautious Fund during the recent past, although it should be read in conjunction with previous editions of *Intermezzo*, wherein we documented some of the salient events in recent months. I also refer you to the *Market commentary – June 2014* report wherein we discuss in detail the market activity during the quarter.

2. The investment position of the Fund

The Fund's asset allocation is shown in Chart 1. Exposure to the equity market totalled 34.9% of the Fund, down from 36.3% in March. Bond exposure increased from 16.3% to 18.4%, while cash represented 42.8% of the Fund, slightly down from 43.5% in March quarter. Property exposure remained unchanged at 3.9% during the quarter.

Chart 1: Asset allocation at 30 June 2014

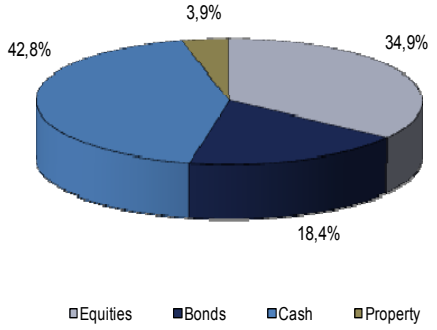
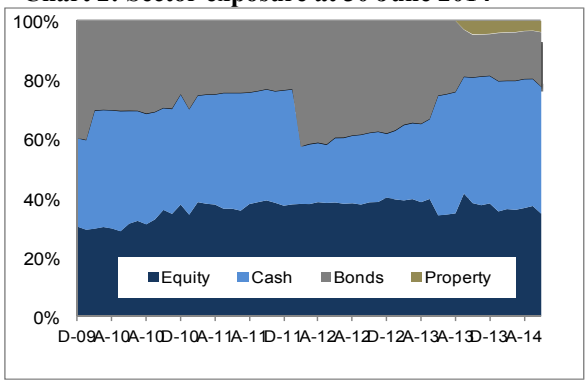


Chart 2 depicts the historical allocation to the major asset classes, expressed as a percentage of the total Fund.

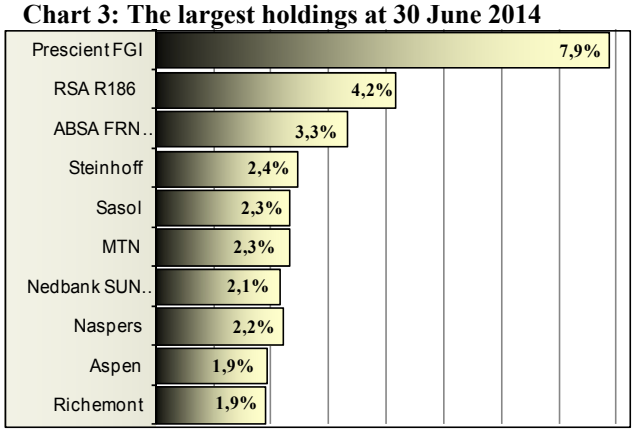
Chart 2: Sector exposure at 30 June 2014



3. The largest equity holdings

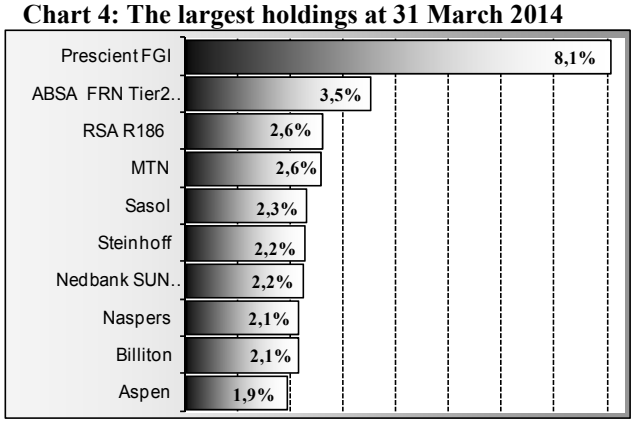
The largest holdings at 30 June 2014 are listed in Chart 3 expressed as a percentage of the Fund's equity portfolio.

Chart 3: The largest holdings at 30 June 2014



The largest holdings at the end of March are listed in Chart 4. The relative rankings changed somewhat during this second quarter and will become evident once you have had a chance to view chart 3 and 4. The largest ten holdings constituted 30.5% of the Fund, marginally up from 29.7% in March.

Chart 4: The largest holdings at 31 March 2014



4. Recent activity on the Fund

The investment objective on this Fund is to *achieve short-term stability and moderate capital growth through the assumption of lower levels of risk.* We would emphasise the "short-term" aspect of this objective, as it is used as a Fund that facilitates members to preserve capital either prior to retirement (1 to 3 years) or post their working life.

The Fund has been designed in accordance with the rules and regulations that govern Regulation 28 of the Pensions Fund Act. It is not open to the retail public and can only be accessed through a company's Provident/Pension Fund or by individuals who have preservation money or wish to either transfer or purchase a Retirement Annuity (RA). These RA's can then be converted into living annuities when the time arises.

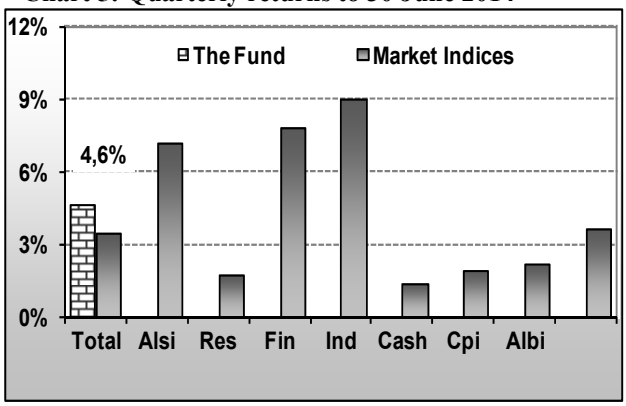
With regards to the asset allocation, equities and cash declined 1.3% and 0.7% respectively, while bonds rose by 2.1% and property remained unchanged during the quarter.

A disproportionate amount of commentary is given on how the equity component of the Cautious Fund has performed. The reason for this is because this sector of the Fund is largely responsible for future growth that the Fund will record and therefore more emphasis is placed on this asset class.

5. The performance of the Fund

Turning to the performance of the Fund, Chart 5 depicts the returns for the quarter against the major indices. ***The un-annualised return on the Fund during the June quarter was 4.6%,*** which can be compared to the Maestro Cautious Fund benchmark of 3.5%. I encourage you to read the commentary on the market movements during the quarter in the document entitled *Market commentary – June 2014.*

Chart 5: Quarterly returns to 30 June 2014



The Fund's quarterly equity return of 5.9% can be compared to the All share index returns of 7.2% We commented extensively in recent letters and *Intermezzo* about the state of the markets during the past few months and refer you to those publications to refresh your memory about the salient features of this period; you can find back copies of *Intermezzo* by clicking here.

After faltering in the earlier part of the year, the local market picked up momentum towards the end of the first quarter and continued to edge up throughout the second quarter. Concerns on the effects of the US Federal Reserve's (Fed) tapering (reduction in asset purchases) faded and the old adage, 'sell in May and go away', proved to be a myth this year, as the local market did not show any signs of easing as it plodded towards the 50 000 index mark for the Alsi. You may recall that during the crisis, this very same index bottomed below the 18 000 level, which now seems like a very long time ago, although it is just over five years back.

During the quarter, we witnessed a reversion to a long-term trend that we have seen over the past number of years i.e. where resources lag the industrial and financial indices. Whereas resources had a strong showing in the March quarter, they lagged in the June quarter. Industrials had an impressive quarter, they rose 9.1%, ahead of financials and resources, which rose 7.8% and 1.8% respectively. Industrials were led higher by large cap rand hedges that had a pedestrian March quarter. The outperformance of industrials aided the Fund's equity component. Gold shares had a marginal positive return for the quarter, although they were volatile intra-quarter. To give you an idea of how volatile the gold sector was during the quarter, in April the index returned 7.3%, in May -12.9% and in June 7.2%. The volatility that characterises gold shares is one of the many reasons we have never looked to invest in this sector – we are of the view that the risk of investing in the sector is not justified by the returns that one is likely to generate over a long time. We are happy to say that this view has been proved right over the time we have managed our clients' funds at Maestro.

What is not evident from Chart 5 is the performance of companies based on their sizes. The small and mid-cap indices failed to keep up with the large caps – as stated earlier, the large cap industrials were the standout performers. The mid-cap index rose 6.0%, while the small-cap index gained 6.1%. The large-caps rose strongly, as the Top40 index gained 7.4% during the quarter, making it a very profitable quarter across the whole size spectrum of the market.

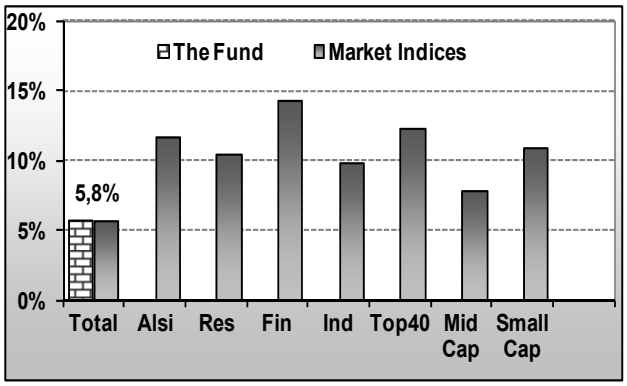
Let us look at the June quarterly returns of some of the Fund's investments. The quarterly returns, excluding dividends, of the largest holdings in the portfolio, were as follows: Steinhoff rose 16.2% (it rose 3.1% in the March quarter), Sasol 7.3% (14.6%), MTN 3.9% (-0.7%), Naspers 7.8% (6.0%), Aspen 6.3% (4.7%), Richemont 10.8% (3.4%), Billiton 6.3% (0.4%), Mr Price 14.9% (-3.9%), Standard Bank 4.5% (7.2%) and Coronation -3.5% (23.8%).

As material as some of the share moves above are, we tend not to read too much into the short-term returns of the Fund's portfolio. We tend to focus more on the longer term returns and I would encourage you to do the same as you draw conclusions on the Fund's performance

The un-annualised return on the total Fund for the year-to-date was 5.8%. This is an aggregate of a flat March quarter and a strong June quarter. The Alsi rose 12.2% year-to-date.

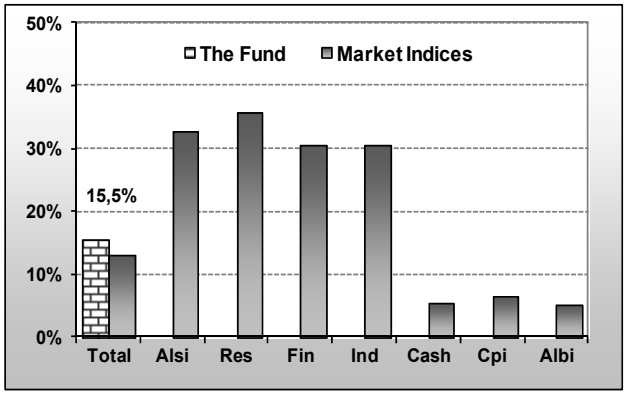
The underperformance during that period is a result of the strength in gold shares in the first quarter, which we commented on extensively in the March quarterly report. Interestingly, financials have been the standout performer for the year-to-date, despite the marginal weakness in the rand.

Chart 6: Year-to-date returns to 30 June 2014



The annual returns to June are shown in Chart 7. ***The annual return of the total Fund for the 12 months to June was 15.5%***. Inflation rose 6.6% over the year and the All bond index rose 5.5%. ***The annual return on its equity component was 26.6%,*** which is in line with the All share index return of 32.8%.

Chart 7: Annual returns to 30 June 2014

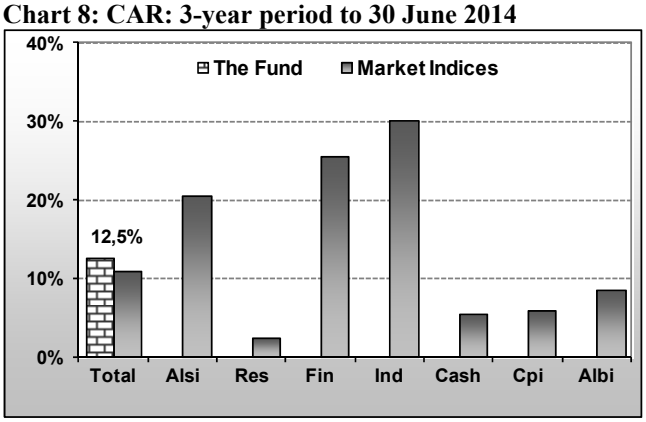


The overweight position in industrials relative to the All share index, and the fact that the portfolio held no gold shares, assisted the returns over the past year. Not shown in the chart are the annual returns of large, mid and small-cap indices, which rose 35.2%, 29.1% and 19.6% respectively.

During the past year, the shares that drove the our clients' returns include Steinhoff, which rose 141.6%, Naspers 71.5%, EOH 70.3%, Coronation 52.2%, Sasol 46.3%, Billiton 36.0% and Mr. Price 34.1%.

The compound annual return (CAR) of the Fund, shown in Chart 8, ***over the three-year period to June 2014 was 12.5%,*** while the equity component returned 18.3% which can be compared to the All Share Index return over the same period of 20.6%.

Chart 8: CAR: 3-year period to 30 June 2014



It is probably worth highlighting that despite our preference for industrials and financials over resources, and the fact that they have outperformed over the long-term, that is not to say there won't be periods when resources are strong, which will likely lead to us underperforming. We remain comfortable with our overweight industrial position and we continue to believe that over the long-term, it will remain a major contributing factor to our outperformance.

Across the market cap spectrum, the large-cap index managed to maintain pace with the mid and small-cap indices, largely thanks to the industrial shares. The three-year compound annual returns of the large, mid and small-cap indices are 20.8%, 18.8% and 24.1% respectively. The respective compound annual returns for the All Bond index and cash over this period were 8.6% and 5.4% respectively.

6. **Closing remarks**

After a flat March quarter, we are happy to see that the Fund had a much better June quarter. Interestingly, the very same positions that worked against the Fund in March quarter are the same ones that resulted in the strong June quarter, namely the absence of gold shares, under allocation to resources and over allocation to industrials with rand hedge properties. As we often highlight, periods of under and outperformance such as these are part and parcel of equity market investing but over the long-term, we believe that our views will be vindicated, as has been the case in the Fund's long-term returns.

Our outlook for the second half of 2014 remains the same as it was at the beginning of the year; we expect a gradual improvement of the global economy, which should remain supportive of equity markets and negative for bonds and cash. Having said that, the insipid economic growth in the first half of the year has resulted in huge expectations for the remainder of the year, at a time when market valuations are not cheap and investors are looking at companies to show reasonable earnings growth. This, we believe, introduces an additional risk over the short-to-medium term.

Other risks we are keeping a close eye on include the continued slowing down of the Fed's monetary easing policy and its effects on emerging markets, geopolitical risks and the Chinese economy. Although these all represent meaningful risks, it is worth highlighting again that it is all part and parcel of investing. Rather than spending an inordinate amount of time worrying about the risks that exist in the market, we spend more time looking for companies that we believe are better able to navigate the challenges that invariably occur in all economies. This strategy has worked well for us and we believe that over time, it will continue to generate higher risk adjusted returns for our clients.

As usual, we are here to be of assistance to you, so please, do not hesitate to call on me if ever you wish to discuss anything about your investment in further detail.

David Pfaff
On behalf of the Maestro team
31 July 2014

MAESTRO

Market commentary – the June 2014 quarter

We comment extensively on market movements in *Intermezzo* and in the letters accompanying client statements, so provide only a summary here of the salient features of market behaviour during the June quarter. The returns of selected equity, bond, commodity and currency markets are shown in Tables 1 and 2.

Table 1: Selected returns: equity markets

	June Quarter (%)	Mar Quarter (%)	Annual Returns (%)	2013 (%)
Japan	2.3	-9.0	10.9	56.7
Hong Kong	4.7	-5.0	11.5	2.9
Germany	2.9	0.0	23.5	25.5
UK	2.2	-2.2	8.5	14.4
US (S&P500) and large cap	4.7	1.3	25.0	32.8
S&P Mid cap	4.0	2.7	23.4	31.6
S&P Small cap	1.8	0.8	24.0	42.4
MSCI World index	***4.2***	***0.8***	***21.6***	***24.1***
Brazil	5.5	-2.1	12.0	-15.5
Russia	16.3	-17.8	8.2	-5.5
India	13.8	5.5	31.0	9.0
China	0.7	0.6	3.5	-5.3
MSCI Emerging market index	***5.6***	***-0.8***	***11.8***	***-5.0***
JSE All share	***7.2***	***4.3***	***32.8***	***21.4***
JSE All share ($)	***6.0***	***3.8***	***23.9***	***-1.6***
Basic materials	1.8	8.6	35.8	-1.8
Financial	7.8	6.1	30.7	19.1
Industrial	9.1	0.8	30.5	35.0
Gold mining	0.1	42.6	18.7	-54.6
Large cap (Top40)	7.4	4.7	35.1	22.8
Mid cap index	6.0	1.8	19.6	13.0
Small cap index	6.1	4.6	29.1	26.3

Introduction

The second quarter of 2014 was yet another profitable quarter for global investors. As shown in table 1 and 2, almost every asset class and sector rose during the quarter, which in itself is quite a remarkable feat. In addition to the expansive gains enjoyed by most markets, we found it noteworthy the manner in which the returns were generated - markets slowly ground their way to all-time highs in an environment characterised by low volatility and volume. The VIX index, a widely followed measure of US equity volatility, also known as the fear gauge, continued to decline during the quarter and at the end of the quarter was trading at seven-year lows.

The best performing markets in the June quarter were emerging market bonds and equities, which were aided by developments in Russia and India. You will recall that emerging market returns in the March quarter were dragged lower by concerns over the geopolitical impasse in Russia and the Ukraine, a situation which in the earlier part of the year threatened to escalate into a full blown Russia versus the West conflict.

During the June quarter, sanity seemed to prevail in the simmering conflict, and while tensions still exist, it appeared as though the worse outcome had been averted. The Indian market was buoyed by the record breaking election that saw over 800 million people casting their vote in the month long election, which made it the largest and longest ever in world history. The Indian equity market surged on hopes that the newly elected Prime Minister, Narendra Modi, will enact reforms which will ultimately grow the economy faster and lift more people from the second most populous nation out of poverty. It is widely acknowledged that India's economic growth has stalled over the past few years, and with the vast majority of the nation's citizens living in abject poverty, it is no surprise that so many people took part in the electoral process. A disheartening statistic concerning India that we came across recently, was the fact that 30 years ago, India's GDP per capita was equal to China's, today it sits at less than a quarter of its neighbours', a clear sign of what ineffectual policies can do to a nation over time.

Developed market central bank profligacy continued to provide an underpin to developed market equities and bonds during the quarter, despite the continued taper (scaling bank of bond purchases) by the US Federal Reserve (Fed). While major global central banks all remain committed to low interest rates in the short-term, during the June quarter we began to see divergent views on when central banks will eventually start hiking rates. The Bank of England (BoE) hinted that interest rates could rise as early as November this year, while the Fed suggested that the third quarter of 2015 remains the most likely timing for rate hikes. The European Central Bank (ECB) remained the most accommodative, with deflation concerns compelling the bank to announce a package that they believe will encourage bank lending and ultimately alleviate deflation concerns. Currency movements were largely determined by the aforementioned posturing by the various banks. Sterling was the best performing currency at the end of the quarter, while the euro and yen were largely unchanged versus the dollar.

Commodities were a mixed bag during the quarter. Precious metals were led higher by palladium, which was the primary beneficiary of the five month South African miners' strike and the conflict in Russia, two of the world's largest producers of the metal. Interestingly, over the entire duration of the above-mentioned supply disruptions, the platinum price barely rose, an indication of the oversupply in the platinum market and the pedestrian growth in European car sales, the largest end user of the metal. The oil price edged up towards the latter part of the quarter, as developments in the Middle East threated to limit supply, which has been well managed over the past few years and has resulted in the oil price hovering around $110 per barrel.

Table 2: Selected returns: bonds, commodities, currencies

	Jun Quarter (%)	Mar Quarter (%)	Annual Returns (%)	2013 (%)
SA All Bond index	2.5	0.9	5.5	0.6
SA Cash	1.5	1.3	5.4	5.2
Barcap Global Agg. Bond index	2.0	2.4	4.4	-2.6
Emerging market bonds	4.8	3.4	12.0	-3.3
US 10-year bond	2.7	3.4	2.8	-7.8
US Corporate bond	2.9	3.0	8.0	-1.5
US High yield bond	2.6	3.0	11.8	7.4
Cash (US dollar)	0.0	0.0	0.1	0.1
DJCS Hedge index	1.9	0.9	8.8	8.4
Brent (Oil)	4.3	-2.7	10.0	-0.3
Gold	1.8	7.5	10.3	-27.8
Silver	4.5	2.4	10.7	-34.9
Platinum	2.7	4.5	10.6	-11.1
Palladium	11.0	8.7	34.4	1.7
Copper	4.6	-10.1	2.3	-7.1
Nickel	19.3	12.7	37.1	-18.5
Baltic Dry index	-39.5	-39.7	-29.0	225.8
CRB Commodity index	1.8	-14.2	12.1	-4.1
S&P GS Commodity index	2.0	2.3	7.7	-1.3
Euro dollar	-0.7	0.0	5.3	4.5
Sterling dollar	2.6	0.7	12.7	1.9
Swiss franc dollar	0.4	-1.7	-6.3	-6.7
Rand dollar	1.2	-0.4	-6.7	-19.0

The global economy

Economic data pointed to a better second quarter than the disappointing growth seen in the March quarter. You will recall that the first quarter of the year was heavily distorted by the Chinese Lunar holidays and severe weather in the US, which rendered most data prints from the US redundant for the first few months of the year. Early indications seem to indicate that the US economy rebounded enough in the second quarter to make up for the weakness in the first quarter, which makes the second half of the year a critical period in determining the US's growth for 2014.

The Chinese economy also had a reasonable showing, by their own standards, with growth for the June quarter printing firmly in line with the government's target of 7.5%. Among major developed economies, the UK has been the standout performer. During the quarter the UK's economy reported growth of 3.0%, an impressive showing for a developed nation, and most of this was driven by the surge in UK house prices. You may have read and heard about the strong gains in UK house prices over the past few years, which have led many to question if there isn't a bubble in that region's property market, which is an understandable concern with the housing crisis still fresh on investors' minds. The Bank of England certainly believe that the surging house prices are a concern, and so have not only indicated that they are likely to increase interest rates sooner than initially thought, but will also put in place macro prudential policies that they believe should cool the surge in property prices.

Turing to emerging economies; during the June quarter, there was a reprieve in the negative sentiment that emerging markets have endured over the past eighteen months. Negative sentiment towards emerging markets peaked in the first quarter and has gradually improved. Key concerns about emerging markets remain the same, namely, some structural challenges that they face. A number of key emerging markets suffer from current account deficits, which have been magnified by the weaknesses in commodity prices over the past couple of years. The aforementioned is coupled with growing budget deficits and in some cases, political instability. It's important to highlight that these undesirable qualities are not new developments for emerging markets, but rather are only being laid bare because of the change in policy stance by the Fed. As we have previously highlighted, the unconventional policies that have been carried by the US Fed (read: quantitative easing) distorted global markets in ways that will take a long time to fully comprehend. One of the effects of those policies was the search for yield by developed market investors into emerging markets. This development saw emerging market currencies and bonds surge to unprecedented levels. This was all well and good while it was happening, but now with the Fed indicating that interest rates are going to rise, possibly by the middle of next year, investors are no longer brushing off structural concerns in emerging markets as they did a few years back. It is unfortunate that emerging market policy makers did not do enough during the 'good times' to get their houses in order, as this would have insulated their economies in the current bout of negative sentiment. In addition to all the above, another concern that remains in emerging markets is the failings of state capitalism and the murky boundaries between the state and private sectors, which exists across most emerging countries. South Africa is a perfect example of the above, where the state continues to act as an impediment to the private sector.

Table 3: Global growth expectation (%)

GDP growth (%)

	2012	2013	2014F	2015F
Global	3.1	2.9	3.3	3.9
US	2.8	1.9	2.3	3.4
Eurozone	-0.6	-0.4	1.1	1.5
Germany	0.7	0.4	1.8	2.0
Japan	1.4	1.5	1.2	1.5
UK	0.3	1.7	3.1	2.5
China	7.7	7.7	7.8	8.0
India	4.9	4.7	5.8	6.1
EM (Asia)	6.1	6.1	6.4	6.7
EM (Lat Am)	2.9	2.5	1.6	2.7
EM (CEEMEA)	2.8	2.3	2.1	3.2
EM	4.8	4.6	4.7	5.2
DM	1.4	1.2	1.9	2.5

Source: Deutsche Bank

As Table 3 shows, after the slowing down in 2013, the world economy is expected to pick up again in 2014 from growth of 2.9% to 3.3%. It is worth noting that the outlook for 2013 has been downgraded from 3.7% over the past three months. While growth of 3.3% is still an improvement from 2013, we remain concerned that the trend of downgrades that we have seen in the first half of the year continue, which we believe the market has not priced in. The economies that are expected to add the most to world GDP during 2014, relative to their contribution in 2013, are the US, UK and the Eurozone group. It is important to highlight that this is in stark contrast to what we have seen since the crisis, when emerging markets were the bright spots in terms of contribution to world GDP, with developed markets limping along. This change in growth outlook between developed and emerging markets is one of the reasons why emerging market equities and currencies have struggled to keep up with their developed market counterparts over the last year. As we have often emphasised, growth occurs at the margin, so economists and investors tend to focus more on the fact that the growth in developed markets is increasing, rather than the fact that the absolute growth rate in emerging markets is higher.

The improving forecast of the US economy that is illustrated in the 2014 and 2015 years, largely explains the Fed's current policy of tapering and higher US interest rates in 2015. Of course, the key risk to that policy, and to some extent the strength we have seen in risk assets, is that for some reason the growth does not actually materialise. Markets, whether they are for currencies, equities or bonds, tend to discount future expectations into current prices, which is the reason we often say that 'markets are forward looking'. In the current economic environment, where policy is closely aligned to economic data, more so than usual, it becomes a key risk that should the markets be pricing in better than expected data, which fails to materialise, we will likely see heightened volatility in the markets. We have no doubt that though the US Fed has committed to start the process of getting back to 'normal' policy towards the end of this year, should there be any indication that the expected pace of the US economy is slowing down, we will see a continuation of the unconventional policies that have plagued markets for the last few years.

Table 4: Annual rates of inflation (%)

CPI inflation, YoY* (%)

	2012	2013	2014F	2015F
US	2.1	1.5	2.0	2.3
Eurozone	2.5	1.4	0.7	1.2
Japan	-0.1	0.4	2.7	1.7
UK	2.8	2.6	1.6	1.8
China	2.6	2.6	2.2	3.0
India	9.7	10.1	7.0	7.0

Source: Deutsche Bank

Table 4 shows another notable feature that separates developed and emerging economies i.e. the inflation outlook. While developed markets have very little to concern them as far as inflation is concerned, emerging nations are seeing the effects of weak currencies translating into higher inflation. This creates a real conundrum for policy makers in emerging economies, as their conventional tool for high inflation, which is to raise interest rates, will have the unintended consequence of exacerbating the already slowing economies. Rightly so, in our view, many emerging market central banks have decided to take the medicine and marginally increase interest rates, despite the weak growth outlook. This has had the positive effect of slowing foreign outflows and stabilising emerging market currencies. It remains to be seen how sustainable this policy action will be, but for now, it has worked as an effective band aid solution. In our view, the key will be to balance the interest rate hikes in such as a way that they do not choke off growth. It's no easy task, but one that will be both painful for the short to medium term, but appropriate for the long term.

Perversely, while the emerging market complex tries to figure out how to deal with rising inflation, the Eurozone is facing up to the reality that deflation is a real possibility in the region. The strong Euro, weak demand, limited bank lending and declining energy prices, all contributed to the current deflation concerns in the Euro bloc. Policy makers in the region are slowly coming to terms with the reality that deflation is a real threat, although they maintain that they have the necessary tools to thwart off its occurrence, which is what one would expect them to say; admitting that deflation concerns are justified will only intensify the discussion until it becomes a self-fulfilling prophecy.

Global bond markets

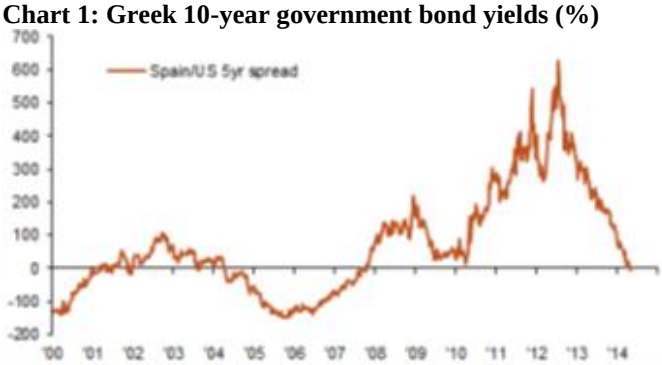
Along with other investors, we continue to be surprised by the performance of bonds this year. Few would have predicted that midway through the year, US treasuries would be outperforming US equities, as measured by the S&P 500. We have spent a fair amount of time trying to understand the continued strength in bonds, and while we feel that we have a judicious understanding of the variables at play, there remains a part of us that senses that perhaps there is something else

that the strength in bonds is telling us about the state of the US economy, that is not priced into the markets. Firstly, to appreciate why we place so much credence to the movement in the US bond market, it is worth stressing that the yield curve, which is widely defined as the difference between the 10-year and 3-month treasury rates, is one of the best known leading indicators or reliable predictors of a slowdown in any economy. Simply put, when 10 year bond yields decline, while short-term yields remain flat or rise, that often indicates that the economy is going to slow down or enter a recession. Like all leading indicators, the above is not fool proof, especially now that the Fed has been buying treasuries (QE) thereby distorting the yield curve. Be that as it may, it will be important to continue watching the movement in bonds over the course of the year, especially with the end of QE drawing nigh. Remember that the Fed's QE policies over the years have resulted in them holding almost 40% of all US treasuries that have a maturity longer than 10 years. This accumulation of bonds by the Fed has obviously played a massive role in determining US bond yields. The concern in the market and what informs most investors' negative outlook on bonds is that with the Fed buying $10 billion worth of bonds less every month, who is going to buy treasuries once the Fed stops buying? Now, this is somewhat of a rhetorical question, as there will obviously be a buyer, the question is at what price?

Despite the strength in bonds in the first half of the year, we expect a pickup in global growth for the remainder of the year, and this largely informs our view of an underweight allocation to bonds. With the US economy expecting to pick up later this year, and the Fed's QE policy coming to end, we believe it is only a matter of time until bond yields reflect this better economic outlook. We do not expect the move to higher yields to be drastic, mainly because we do not believe the Fed will let that happen, but high interest rates are certainly coming, not only in the US, but also in global bond markets.

A development in the bond market that we highlighted in the March quarterly, but is worth repeating as we have seen a continuation of that trend in the June quarter, is the appreciation in the European periphery bond markets. Less than two years ago, headlines were filled with calamitous outlooks for Portugal, Ireland, Italy, Greece and Spain, collectively known as the PIIGS. Since then, the bond markets in those nations have recovered, with Greece and Portugal recently issuing bonds to the market. Chart 1 shows the yield differential between Spain and the US. It is extraordinary to see that the market now essentially regards Spanish bonds as being safer than US bonds over five years – truly remarkable! Remember, that when bond yields decline, as they have recently, prices rise i.e. there is an inverse relationship between bond yields and prices.

Chart 1: Greek 10-year government bond yields (%)



Source: Merrill Lynch

Other developments in European bond markets that are worth highlighting include the following:

- Dutch yields are now close to 500-year lows;
- Italian bond yields are close to 70-year lows;
- German bond yields are only just above their all-time lows;
- The difference between US and German 10-year yields is currently 110 basis points (1.10%), versus the 3-year average of 47 basis points.

Unsurprisingly, African governments have also decided to join the proverbial party and borrow at these unsustainably low interest rates levels – as the saying goes, feed the ducks while they quack! In the last few months, Kenya, Rwanda, Senegal and Ivory Coast have all issued hard currency denominated bonds and predictably, all the issues were oversubscribed at low interest rates. Investors often have very short memories, you may recall that Ivory Coast defaulted on their debt just three year ago, which was not the first time in the country's history, yet they raised $5 bn to be repaid in 10 years with an annual coupon of 5.6% (the issue was also 6 times oversubscribed).

Currency markets

Chart 2: The euro dollar exchange rate

Source: Saxo Bank

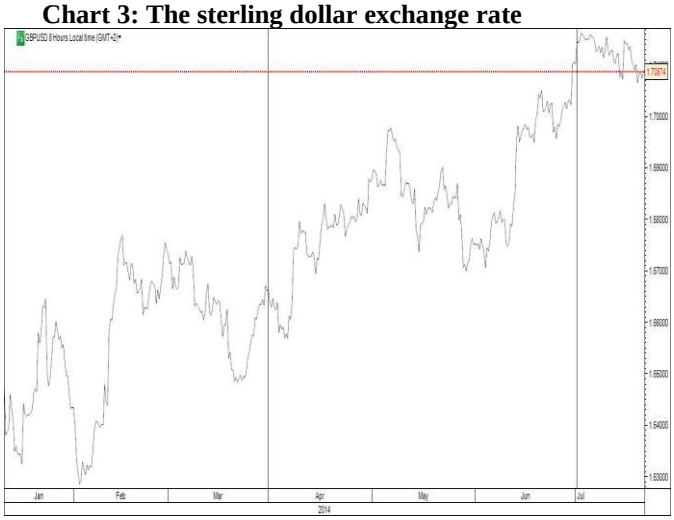
With the odd exception of a couple of currencies, there weren't any major moves in the currency markets during the quarter. One of the most debated currency pairs during the quarter was the euro dollar exchange rate; apart from being the largest economic blocs, the pair were a huge talking point because most investors have consistently been getting that call wrong for probably close to a year. Most investors saw the end of QE as an inflection point where they expected the dollar to strengthen considerably against the euro, a view that has not materialised. We have spent time debating possible reasons for the continued resilience in the euro, despite all the headwinds that the region has endured over the past year, and it became clear to us that many investors undermine the trade demand for the euro. You will be aware the euro bloc is indeed the largest economic trading bloc in the world, with some estimates suggesting that is makes up over 25% of global GDP. Importantly, the largest economies in this region are strong global exporters, not only into the euro area, but into Asia, the Americas and to a lesser extent Africa. Germany, as an example, is a significant player in the motor industry and its vehicles are exported across the world, which creates a strong underlying demand for euros. During the quarter, the Eurozone's trade surplus (which is the net of their exports and imports) continued to increase.

A corollary of a strong euro has been the decline in the inflation rate of the Eurozone over the past year. Economists estimate that the strong euro and slower growth have been the main culprits behind the Eurozone inflation reaching a four and half year low in June. With annual inflation for the region hovering around 0.5%, significantly below the central bank's target of 2%, it is no surprise that the ECB took some action. While it often is hard for consumers in countries where inflation is structurally high, like South Africa, to understand why low inflation is of concern, looking at Japan, as an example, should provide ample evidence that deflation is in fact a greater challenge for policy makers to contend with than inflation. Deflation results in consumers postponing consumption, firms become reluctant to borrow and invest, which often triggers disruptive deleveraging. History shows us that this ultimately leads to deep recessions (depressions) at a time when policy makers have no tools, because interest rates will already be extremely low. This threat forced the ECB to announce a package that they believe will prevent a deflationary eventuality. The ECB cut already record low interest rates, resulting in deposit rates becoming negative – this means that banks will incur costs for storing money with the ECB. The central bank also afforded banks the ability to borrow from the ECB at a very cheap rate of about a quarter of a percent per annum, with some loose conditions attached to ensure that banks do not abuse the ECB's liberality. Critically, the ECB also said that they are exploring a US-style QE program, where they buy bonds to add liquidity into the financial system. The initial reaction to the package was a weakening in the euro, although this weakness was short-lived.

We viewed the rebound in the euro as an indication by the market that investors remain unconvinced as to the efficacy of the ECB's measures. It remains to be seen if the Eurozone will escape what would be a damaging outcome should deflation occur. While we do not have Eurozone deflation as a base case view over the remainder of the year, we certainly view this as a potential risks to the market.

Sterling has been one of the standout performers for the year-to-date, on the back of a strong economic recovery which forced the central bank to reconsider its interest rate path over the next year. At a time when most developed market policy makers are still holding an easing bias in their monetary stance, the BoE's position is certainly an outlier. This disparate view by the BoE goes a long way to explaining why investors continue to pile into sterling, which has pushed the currency to a five year high.

Chart 3: The sterling dollar exchange rate



Source: Saxo Bank

One of the key drivers of the UK economy has been the rampaging house prices that have grown by close to 30% in some areas over the past year. This theme, of a specific asset class driving up growth, has stirred much debate in other countries, and is something of a conundrum to central bankers; on one hand, central bankers want their economies to grow, but at the same time, they are concerned that their unconventional policies have led to some high valuations in certain asset classes. The Fed is in a similar situation and the Fed Chairperson, Janet Yellen, recently commented that she is concerned about the valuation in high yield bonds and some tech and biotech companies. However, central bankers cannot be too disparaging in their remarks, because after all, they are largely responsible. It would be quite bizarre if a few years from now we are once again looking back at a new crisis that would have been caused by central banks' policies that were enacted to solve a previous crisis.

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Global equity markets

In many respects, the performance of equity markets in the June quarter was a continuation of what we have seen over the past year. Equities, both developed and emerging, continued to be driven up by central bank policy. Worth noting is the similarity in the year-to-date returns and annual returns, with respect to the respective markets re-rating, as opposed to increases in the companies' underlying earnings. Take the Indian market as an example below, expectations over the newly elected government's policies have led to the Indian market rising 13.8% in the June quarter, with no material change in the earnings expectations of the underlying companies.

Chart 4: Global returns to 30 June 2014

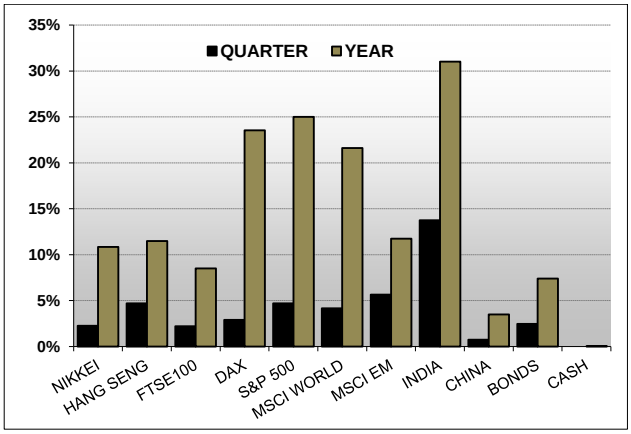
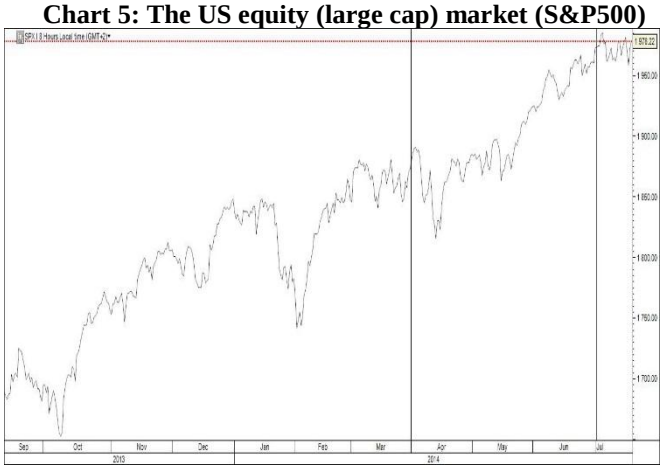


Table 1and Chart 4 depict the returns from major developed and emerging markets. The impressive annual returns still stand out and speak of investor willingness to take on risk. During the quarter, the Chinese market was the worst performer, as it rose only 0.7%. The Japanese and UK markets performed better, as they rose 2.3% and 2.2% respectively. The rest of the markets made notable moves up with the German market up 2.9%, US and Hong Kong 4.7%. The best performing market among those we track closely was the Indian BSE, which rose 13.8%.

Chart 5: The US equity (large cap) market (S&P500)

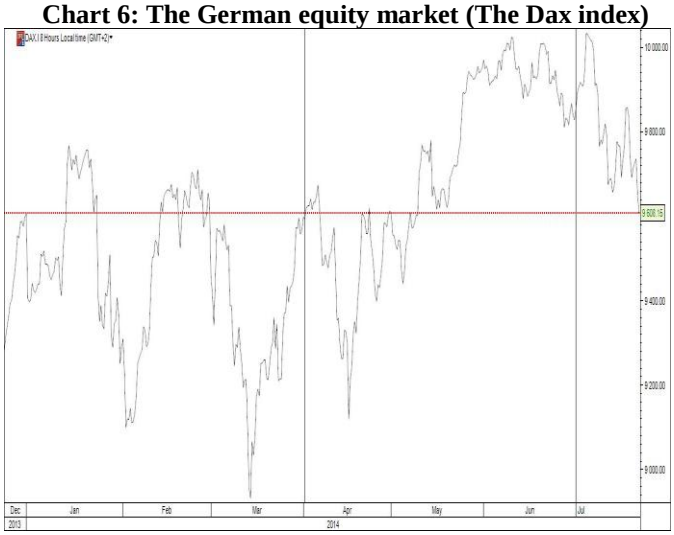


Source: Saxo Bank

Looking at the annual returns, developed markets continue to dominate the list of best performers. The S&P 500 has led the gainers, it is up 25.0% over the past year, which is slightly above the German Dax, which rose 23.5% over the past twelve months. The MSCI World index, a proxy for global equities, rose 21.6% over the year.

In the March quarter, the US and German markets repeatedly reached all-time highs, as seen in Charts 5 and 6. What we found to be of interest during the quarter was the manner in which the all-time highs were reached – markets slowly ground to the top with small daily moves. We sensed that the gradual gains in markets had something to do with investors who have been on the side-lines, now incrementally allocating to equities. When one looks at the longer term returns in the US (chart 5), then one can clearly see that the market has been on a strong upward surge for over two years. Seeing charts such as the one above makes us cautious, as we know that markets do not go up in a 'straight line'. We would go as far as to say that it is healthy for the market to correct every now and again, as this makes investors more comfortable to enter the market.

Chart 6: The German equity market (The Dax index)



Source: Saxo Bank

It is worth pointing out that despite the strength in markets, we currently do not view developed markets as overly expensive, but we also do not see them as being cheap. This means that there are certain areas in that market where we believe there will be earnings growth to support current valuations, while there are sectors that are starting to look concerning. Having said that, even within specific sectors, there are shares that look expensive, but that we feel the valuation is justified. Technology shares for example have received a lot of publicity for their lofty valuations. Some of them are certainly overpriced, like social media stocks that have no earnings to report, but numbers of users. However, some tech shares have been generating earnings and good

cash flow, which we believe is a critical differentiator between the 'good and bad' tech shares.

Commodity markets

Having mostly declined during 2013, commodities were generally positive in the June quarter. Precious metals, which include gold, platinum, palladium and silver, had a positive quarter, where the outperformer was Palladium, rising 11.0%. Iron ore had a disappointing quarter, it plunged 16.8%, on the back of slower imports into China. Nickel had a spectacular quarter, it rose 19.3%, after Indonesia, a key producer, banned exports of unprocessed ore. Soft commodities had an unusually weak quarter on the back of good U.S crop weather. Corn fell 15.5%, cotton 15.3%, sugar 6.5% and soybeans 4.3%.

The local economy

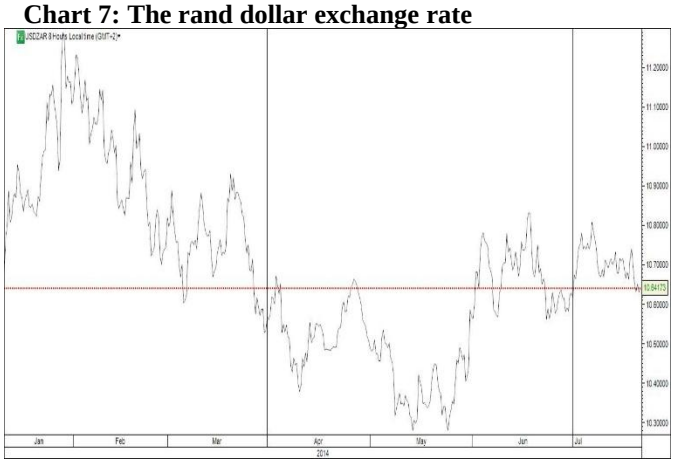
We have touched on a number of features such as commodity prices and the dollar, which have a material impact on the South African (SA) economy. On the whole, the SA economy had another weak quarter that was plagued with labour unrest, disruption to mining production and related industries such as manufacturing. At the time of writing this quarterly, the NUMSA strike was still ongoing and there was a real possibility of the country being dragged into a technical recession. This is at a time when the rest of the global economy is picking up and in some way is reminiscent of the commodity boom in the previous decade, when SA did not participate fully because of local constraints like insufficient infrastructure.

Over the past eight months, economists, including the South African Reserve Bank (SARB), have halved their growth expectations for 2014. Currently, economists are expecting the economy to grow by 1.7% this year, which is a far cry from the government's ambitious 5% target, or the expectation of 3.2% at the beginning of the year. We have commented extensively in previous publications about the current account deficit, SA's Achilles heel. This critical measure remains under pressure as a result of the ongoing metal workers strike. The NUMSA strike affects around 70% of SA's vehicle exports and the longer that this strike goes on, the more vulnerable the economy and the rand will become.

As expected, inflation continued to edge up and is firmly outside the SARB's target band, with the risk being that it will deteriorate further. The above backdrop, coupled with unions continuing to make huge wage demands, compelled the SARB to increase interest rates by 0.25% just after the end of the June quarter. While the increase is in all likelihood inconsequential, we view it as the central bank firing a warning shot to say that they are aware of the potential downward spiral in the inflation outlook. Having said that, with growth as weak as it is, one has to wonder if the central bank will continue to hike rates, while the economy slows further. Additional tightening will only serve to cripple the already weak demand as consumers continue to grapple with high indebtedness and low disposable income.

All the aforementioned played a part in the ratings agencies decision to downgrade SA sovereign bonds in the June quarter and unfortunately, SA remains on a negative outlook, which means another downgrade could occur in the next few months.

Chart 7: The rand dollar exchange rate

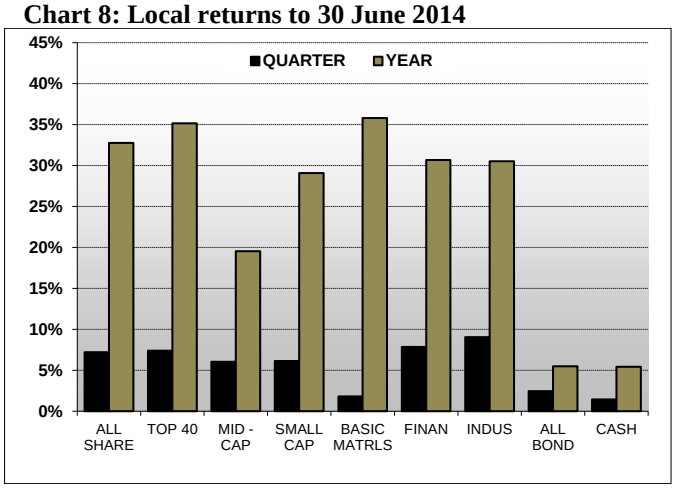


Source: Saxo Bank

Local investment markets

Despite the slowing economy, the SA equity market still managed to post great returns in the June quarter. The June quarter was a reversion to a trend that we saw in 2013 i.e. where returns were boosted by the industrial and financial index, while basic materials lagged. This underperformance (1.8% gain) should be seen in the context where basic materials rose 8.6% on the previous quarter. A lot of the volatility in the resource sector should be attributed to gold miners that have been extremely volatile. Just to give you an indication of how volatile gold miners have been for the year-to-date – in their best performing month, the gold miners were up a whopping 27.6% and in their worse month, they were down 12.9%!

Chart 8: Local returns to 30 June 2014



The All share index rose 7.2% in the quarter, led higher by large caps that rose 7.4%, ahead of the mid and small caps that rose 6.0% and 6.1% respectively. Industrials rebounded from their disappointing March quarter and rose 9.1% in the June quarter, while financials rose 7.8% and resources 1.8%.

Turning to the local bond market, the June quarter was better than the March quarter. Bonds rebounded and posted a gain of 2.5%, which brought its annual return to 5.5%. Considering that the first comments concerning tapering occurred about a year ago, it isn't surprising that bonds have endured a difficult twelve months since then. You will recall that primary local beneficiaries of the Fed's QE policy have been the currency and bond market, which is why the tapering process continues to have negative impact of the bond market, which has just about kept up with the 5.4% cash return over the year.

In closing

After a brief hiatus in the March quarter, markets have resumed their upward grind that we have seen for the past five years since the depths of the crisis. We have had numerous discussions with clients and within the team about the current market environment, and it is safe to conclude that what we are seeing in markets is quite remarkable. Much of what we are experiencing now, in the form of central bank support, is unprecedented and the jury is still out on how we will get back to 'normal' economic policy in developed markets. If the growth trajectory in the US continues as we have seen over the past couple of months, we are likely to see for the first time in a few years how markets cope without the Fed's support. Some have suggested that when the Fed steps back, the ECB will step in with their QE program, which will support markets, but that remains to be seen. For us, we view the return of 'normal' policy to be a key risk for markets in the second half of the year - economic growth will need to come through and companies will need to deliver on earnings - which we haven't seen enough of over the recent past.

As far as South Africa is concerned, there are a glut of challenges that the economy has to navigate in the second half of the year; rising inflation, higher interest rates, Fed's continued tapering, labour unrest, a slowing economy and potential ratings downgrades. Similar to other emerging country peer currencies, the outlook for the rand remains uncertain and we are likely to see renewed pressure on the currency as the economy slows and the Fed continues to decrease their asset purchases. The negative sentiment towards emerging markets is likely to continue, although there have been signs that global investors are willing to differentiate between emerging economies that have better fundamentals than the rest.

Despite our cautious tone above, it is worth remembering that the world economy, and South Africa in particular, have successfully negotiated their way out of worst crises in the past. We remain convinced that the best way to approach markets and specific companies that we look to invest in, is by looking for good management who create value for shareholders, reasonable earnings growth and good cash generation, which overtime results in higher share prices.

Victor Mupunga
On behalf of the Maestro Investment Team

22 July 2014