MAESTRO
Equity Fund

PRESCIENT
MANAGEMENT COMPANY

The Maestro Equity Fund

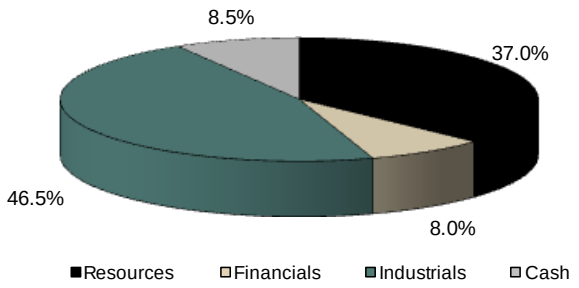
Quarterly report for the period ended

30 June 2008

1. Introduction

This report focuses on the investment activities of the Maestro Equity Fund during the past quarter. It should be read in conjunction with Maestro's monthly investment letter, *Intermezzo*, and the monthly Fund Summaries sent to investors.

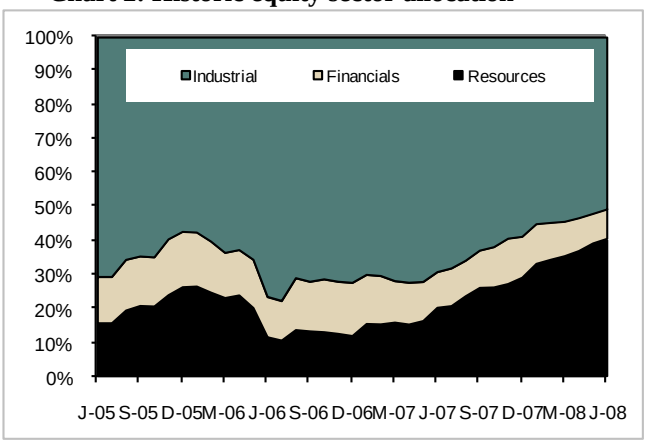
Chart 1: Asset allocation at 30 June 2008



2. The investment position of your portfolio

Chart 1 depicts the Fund's sector allocation at the end of June. Exposure to the resource sector totalled 37% of the Fund, up from 32.4% in March. Financial exposure declined from 9.3% to 8.0% and industrial exposure declined from 49.7% to 46.5%. Cash represented 8.5% of the Fund, down from 8.6% at the end of March. Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

Chart 2: Historic equity sector allocation



3. The largest equity holdings

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

INVESTMENT OBJECTIVE

The Fund's objective is to produce above average long-term returns by investing in the South African equity market. It will simultaneously aim to assume less risk than the risk inherent in the market itself. The Fund adopts a conservative investment philosophy.

FUND BENCHMARK (BMK)

The Fund will measure itself against the FTSE-JSE All Share Index. It will also use an internal benchmark, the Maestro Equity Benchmark, which consists of an equal weighting of the FTSE-JSE Top40 and Findi30 indices which effectively yields an index that is roughly equally weighted between the resource, financial and industrial sectors.

LEGAL STRUCTURE

The Fund is a scheme in the nature of a trust known as a collective investment scheme. The portfolio manager is Maestro Investment Consulting, an approved Financial Services Provider in terms of the Financial Services and Intermediary Act, operating under licence number 739, and the Financial Institutions (Protection of Fund) Act. This portfolio operates as a white label fund under the Prescient Unit Trust Scheme, which is governed by the Collective Investment Schemes Control Act.

FEE STRUCTURE

The maximum initial fee is 2.0%. The investment management fee is 1.75% per annum. The *annual* total expense ratio (TER) for 2007 in respect of class A was 2.17%.

FUND SIZE: R22 445 726

MANAGEMENT COMPANY

Prescient Management Company Ltd
Box 31142, Tokai, 7945

TRUSTEE AND AUDITOR

Trustee: Nedbank Limited
Auditor: KPMG Inc.

PORTFOLIO MANAGER

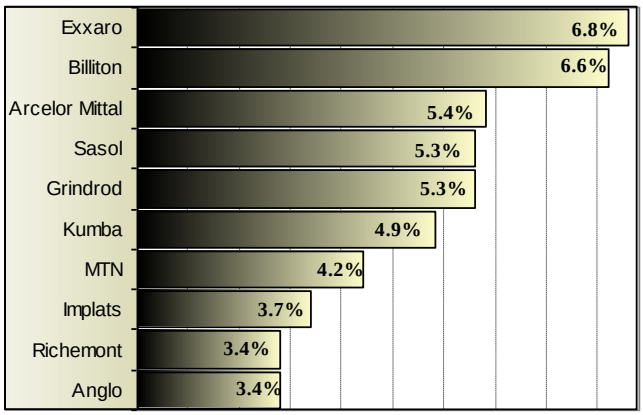
Capstone 96 (Pty) Ltd t/a Maestro Investment Consulting

ENQUIRIES

Maestro Investment Consulting
Box 1289
CAPE TOWN
8000

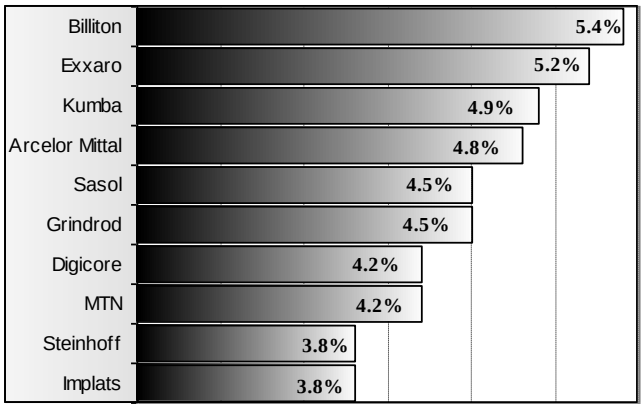
Fax: 021 674 3209
Email: equityfund@maestroinvestment.co.za

Chart 3: The largest holdings at 31 March 2008



Those at the end of March are listed in Chart 4 for reference purposes. Richemont and Anglo displaced Digicore and Steinhoff in the ten largest holdings at quarter-end. There were 31 counters in the Fund at quarter-end, unchanged from March, the ten largest of which constituted 49.0% of Fund versus 45.3% in March.

Chart 4: The largest holdings at 31 December 2007



4. Recent activity on the portfolio

The investment objective on this portfolio is to *achieve long-term growth through the assumption of moderate risk.* It is against this objective that the activities and performance of the portfolio should be assessed.

There were no major changes to the Fund during the quarter.

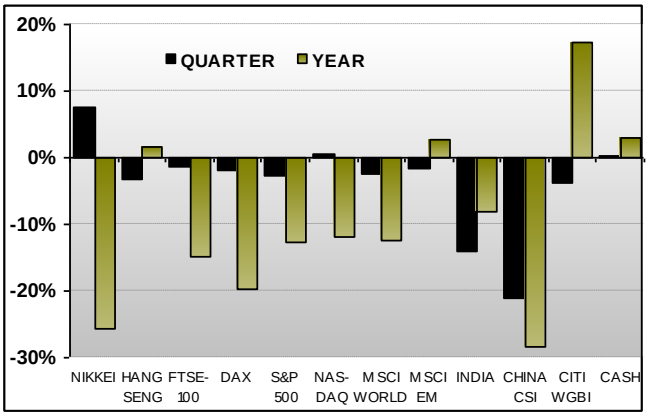
5. A review of the recent investment environment

At the time of writing the March Quarterly Report I was hoping that at this stage I would be able to report on a better (June) quarter. Although I didn't expect us to be "out of the woods" at this stage, it was hard to believe we could have a repeat of the tumultuous March quarter, characterized as it was by huge volatility and price weakness. Well, I was right and wrong; "right" in respect of there being *less* as opposed to *no* volatility; and other than one or two major developments we have not seen a substantial change in the factors affecting investment markets. However, I was "wrong" in respect of under-estimating just how severely investor sentiment would deteriorate, particularly on the local equity market, and how weak global equity markets would be.

Developments during the June quarter, which will go down in history as another remarkable and "thank-heavens-its-over" quarter, have been covered to some extent in recent editions of *Intermezzo*; I would urge you to review these in order to gain the necessary background against which this Report is written. There is just not enough space to report all that happened; my comments here are synoptic at best in an effort to highlight the *most* significant developments that affected your investments during the past quarter. We are experiencing remarkable and historic times in investment markets. While they are not necessarily profitable, they afford us the opportunity to learn a great deal and prepare our thinking for when the economic cycle improves and investment conditions change.

Turning to the market behaviour during the June quarter, global equity markets were characterized by "moderate" weakness during the *quarter*, as can be seen from Chart 5. It feels like markets were a lot weaker than they actually were – just look at the *annual* returns in the Chart. The explanation behind this strange anomaly is as follows: markets have been in a steady down trend since October last year but "bounced" in the first half of the June quarter, only to fall sharply in the second half to end the quarter marginally lower. But the trend remains firmly down; the declines on most share prices have been severe.

Chart 5: Global market returns to 30 June 2008



If we trace a time line back to the beginning of the quarter markets were breathing a collective sigh of relief after the rescue of Bear Sterns investment bank in the US by JP Morgan. There was a feeling - misplaced and not shared by us - that the worst of the global credit crisis was over. Markets rallied strongly (the S&P500 rose 12.1% and the Dax 15.0% from peak to trough in this period), the US Federal Reserve (the Fed) indicated

that markets were stabilizing and, as hard as it is to believe, the oil price was $100. Then things started going pear-shaped: the oil price rose 11.0% in April and another 14.7% in May. In mid-April European Central Bank (ECB) Governor Trichet hinted that the next movement in European interest rates would be *up*, exactly the opposite of what markets were expecting. The rest, as they say, is history, with the exception of the oil price, which continued to surge, eventually trading above $147 and ending the quarter up an astonishing 39.4%. As an aside, the gold price actually *declined* during the quarter, ending 0.4% lower - so much for its traditional role as a hedge against inflation and a protector of value in times of uncertainty!

After the Trichet's comments, which turned out to be prophetic, given that European rates were duly raised by 0.25% to 4.25%, global equity markets headed steadily lower, gripped by fear of resurgence inflation, slowing economic growth and further distress in the global banking system. The pace of declines accelerated during June, leaving markets reeling at the end of the quarter and nursing **the greatest six-month losses since 1970**.

If I had to sum up the most influential factors on the markets during the quarter, they would be as follows:

- *A rampant oil price:* you don't need me to tell you that the oil price has risen dramatically; it rose 39.4% and 96.4% during the quarter and year to June respectively.
- *A general rise in commodity and food prices:* commodity prices rose during the quarter, although to a lesser extent than oil, with the S&P GSCI index (the old Goldman Sachs Commodity index) and CRB index up 25.3% and 19.6%, and 69.7% and 46.6% during the quarter and year to June respectively. Most governments and public authorities have, correctly, come to realize the plight of the poor, in particular, under conditions of surging food prices. While this is to be welcomed and expected, it has increased the bad news flow, with each subsequent release of the latest inflation rate making it into the headlines, adding to what were already gloomy conditions. Distortionary food subsidies, particularly in developed countries, freak weather conditions (floods in some places and droughts in others) leading to poor harvests, industrial unrest and labour disputes are among the factors contributing to the rise in food prices.
- *An ongoing global credit crisis:* financial markets in developed economies and the banking sector in particular are still gripped by the worst banking and credit crisis in recent history. $400bn of assets have already been written down on bank's balance sheets and there is widespread agreement that about as much still needs to be written off in the future. Why this is relevant, apart from explaining the decimation of bank's share prices - refer to Table 1- is that banks have significantly tightened their lending criteria, making it that more difficult - even for financially healthy customers - to obtain credit. Banks are more focused on protecting their remaining assets and executives more concerned about hanging on to their jobs than on the banks' traditional role of lubricating the economy. Thus, the dramatic policies enacted by the monetary authorities aren't finding their way through to the people who need it most and most banks have not lowered their interest rates much despite the significant rate cuts by the Fed. This has forced central banks to explore non-traditional means to assist over-leveraged customers, which has in turn raised the levels of risk in the system – so-called systemic risk - even further.

Table 1: Recent financial sector price movements

Company	Return for periods to 30 June 2008 (%)		Peak to trough change (%)
	6-month	Annual	
Bear Sterns	Didn't make it – taken over by JP Morgan		
Goldman Sachs	-16.9	-19.1	-30.3
Lehman Brothers	-68.0	-73.3	-83.3
Merrill Lynch	-39.9	-62.1	-71.5
Ambac Financial Group	-95.4	-98.7	-98.7
MBIA	-78.7	-93.6	-94.1
Freddie Mac	-52.4	-73.3	-91.6
Fannie Mae	-51.2	-70.1	-89.2
Bank of America	-42.3	-53.9	-55.7
Citigroup	-41.9	-67.3	-71.8
Indy Mac	Gone belly up - in process of being rescued		
S&P Finan (index) ETF	**-30.0**	**-44.7**	**-53.0**
JSE Financial index	**-25.4**	**-27.2**	**-38.3**
Abil (African Bank) **	-28.5	-21.1	-40.9
Absa	-26.1	-37.6	-40.5
Firstrand **	-32.7	-41.1	-48.6
Investec Bank **	-24.5	-48.3	-54.8
Standard Bank **	-23.8	-22.4	-45.0
Alpha Bank *	-25.3	-24.9	-29.0
Barclays	-41.1	-58.8	-62.0
Credite Agricole	-37.5	-53.3	-58.1
Erste Bank *	-16.4	-36.6	-42.9
Lloyds TSB	-34.2	-46.8	-51.8
National Bank of Greece*	-39.3	-35.8	-41.6
Northern Rock	Didn't make it – nationalised by UK gov.		
Royal Bank of Scotland	-43.2	-66.8	-66.8
Societe Generale	-39.5	-57.8	-61.0
Raiffeisen Intl Bank *	-16.9	-29.9	-35.2

* held in Central Park Global Balanced Fund
** held in your Fund

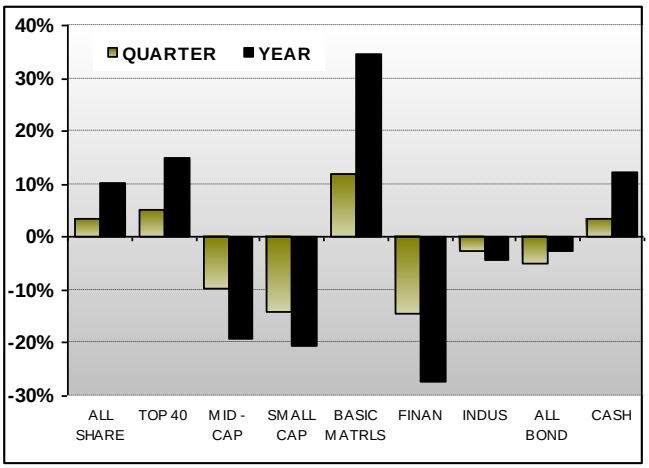
Table 1 contains a lot of detail but in it I have shown a spread of US, European and SA banks, including ones held in your Fund and in Central Park Global Balanced Fund. The Table is a good example of "market or sector risk" – no matter which bank you held and in which jurisdiction it operates, you would have lost money. The "peak to trough" column

shows the change in prices over just more than a year; the trough for most banks – at least at the time of writing – was 15 July 2008, when Freddie Mac and Fannie Mae were on the verge of "falling over" – we will return to this topic later in this Report.

- *A slowing US economy and the deteriorating financial position of the US consumer:* there is widespread evidence to suggest that the US is well into a recession, although this has not been made official yet. As a matter of interest the National Bureau for Economic Research (NBER) is the US government body that has the official responsibility for dating US recessions. It normally does so some time after they begin; even more ironically recessions have in the past ended about one or two months after the NBER has dated the start of the recession and "made it official!" There has been a lot of debate about the definition of a recession, but it can't detract from the fact that the US has slowed dramatically and the US consumer is in dire straits. Bearing in mind that US consumers account for 18% of global GDP and that it was his excessive spending that took the global economy to such great heights before the current slowdown, an intimate knowledge and analysis of his or her financial position is vitally important. Simply put, the US consumer first over-spent on his equity investments, which led to an equity bubble that burst in 2000, and then on his property investments, that led to a property bubble that burst in 2007. And to add insult to injury, he did most of this spending on debt. He now finds himself with declining equity investments, a mortgage (bond) larger than the market value of his home (which will probably decline another 25% in due course) and he may well now be under threat of losing his job. The chickens are now finally coming home to roost – in a big way! I will return to this point later in the Report.
- *A sick dollar:* after the latter description of the US consumer it is not difficult to see why the dollar has been so weak. Of course, it is more complicated than that, but the fact remains that dollar weakness was a major feature of the past quarter. It declined 14.3% against the euro during the past year but has actually gained 0.5% during the quarter. This small display of strength hides its inherent weakness, which is the cause of many other problems in the markets today. The more the dollar declines, the more the prices of dollar-denominated assets such as oil and food, increase. There has been a one-sided relationship between the dollar and the oil price of late: as the dollar has declined, so the oil price has risen (which is logical). But the oil price has not declined much when the dollar firmed, from which one can infer that the oil price is not just a symptom of the weak dollar. Our view of ongoing dollar weakness does not bode well for the oil price if these strange one-sided relationship continues, which we suspect it will.

If you have time to revisit the March Quarterly Report, you will see that many of these factors are similar to ones that wreaked havoc in markets during the first quarter. It was literally a case of "more of the same" – it was just the extent of change that took everyone by surprise.

Chart 6: SA market returns to 30 June 2008



Turning to the South African markets the discussion of the influential offshore factors provides sufficient explanation for what drove local equity and bond markets lower during the quarter. At least that much is true of the financial and industrial sectors, which ended the quarter sharply lower – refer to Chart 6 - despite significant losses going into the quarter. On the other hand basic material (resource) shares headed sharply higher. Before returning to this strange SA equity market characteristic, let me mention a couple of features of the local markets during the quarter:

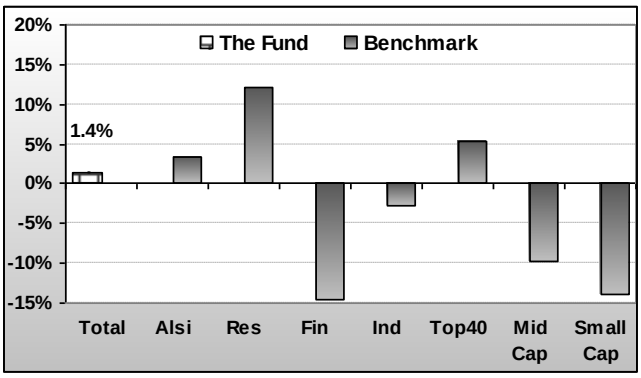
- *Rising inflation and interest rates:* it will not be news to you that SA inflation rate is rising strongly and consequently interest rates have been increased aggressively since 2006. The reason I mention it here is that it had, not surprisingly and amidst all the other variables affecting the local markets, a strong bearing on the deterioration of investment sentiment. The financial health of the consumer is being put to the test and in all likelihood will be found wanting. Consequently, consumer-related shares and those providing services to them such as banks were under severe pressure.
- *The rand:* I wonder if a quarter will ever go by when we don't touch on this "hardy annual?" Ironically, in this quarter the news was surprisingly good: hard as it is to believe, in the midst of all the market mayhem and deteriorating global investor sentiment the rand actually *rose* 3.8% and 4.4% against the dollar and euro respectively. It should be borne in mind that it ended the previous quarter very weak – it declined 9.9% and 22.8% respectively during the past year. The rand's behaviour during the quarter provided more proof of how unusual markets are at

present. Traditionally when the dollar weakens the rand firms. However, whereas the dollar was for all intents and purposes flat during the quarter the rand strengthened 4.4%. Similarly in the first quarter the dollar weakened 7.6% but the rand weakened even more, falling 15.9% against the dollar. When markets eventually "normalize" –admittedly that may be some way away – we expect the traditional relationships to re-assert themselves. And a final point on this score – the earlier point of rising SA interest rates provided lots of support for the rand and saw, we believe, ongoing activity in the "carry trade" whereby global investors borrow in a low-yielding currency such as the yen and Swiss franc and invest into high-yielding ones like the rand. This activity must have lent additional and welcome support to the rand.

- *Increasing disparity between basic material and financial returns:* we have alluded to this feature of the market many times in the last few months, but we have to raise it again as it played a significant role in the return of the All share index as well as your portfolio. In a nutshell, despite the relatively firm rand the prices of basic material shares have continued to rise sharply and those of financial and industrial companies decline, to the point where I can't remember such a large disparity ever having existed in my career. Prior to giving you the extent of this disparity, remember to look at the differences between the returns of the basic materials and financial sectors on the charts below that show your Fund's returns. You will be amazed to see just how wide the differences are. During the March quarter, there was a 30.7% difference between the (quarterly) returns of the basic materials (+17.9%) and financial (-12.8%) sectors. During the June quarter, the quarterly difference was 26.6% (basic materials rose 12.1% and financials declined 14.5%). That means that during the first six months of this year the combined difference was 57.5% (basic materials rose 32.1% and financials declined 25.4%) and the difference between the two during the year to end-June was no less than 61.7%! We acknowledge that there is a difference between the fortunes of the two sectors, but we don't believe that it is that large – at least not in a South African context. But it illustrates two important aspects which we need to bear in mind when assessing the future of the markets in coming months: *firstly*, that sentiment is now the pre-eminent driver of equity markets at present and *secondly* that valuation anomalies can persist for some time and in fact even worsen before reverting back to their historic or fundamental levels.

These then, are but some of the factors we have had to contend with in the daily management of your assets. Let's now turn to how those assets have fared through these turbulent times.

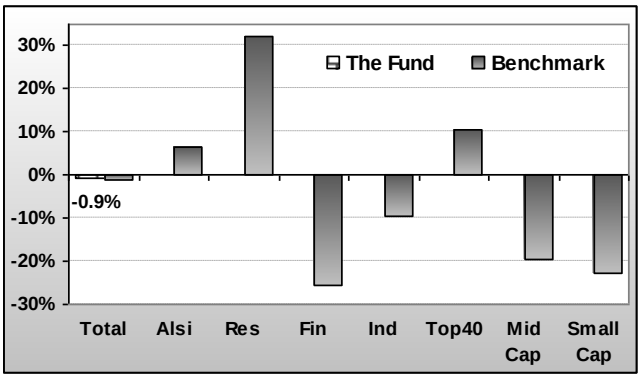
Chart 7: Quarterly returns to 30 June 2008



6. The performance of the Fund

Turning to the performance of the Fund Chart 7 depicts the returns for the quarter as well as those of the major indices. ***The un-annualised return on the total Fund during the June quarter was 1.4%*** which can be measured against the return of the Maestro equity benchmark of 0.0% shown along-side the Fund's return in the "Total" column in Chart 7, and All share index gain of 3.4%. As you are aware by now the resource sector dominated the quarter with a return of 12.1%. This is in stark contrast to the quarterly *declines* of 14.5% and 2.7% in the financial and industrial sectors respectively. The mid and small cap indices posted quarterly *declines* of 9.8% and 14.0% respectively. Bearing these disparate sector returns in mind and juxtaposing them against the industrial and mid- and small cap bias of your portfolio, you will understand why the Fund lagged the All share index during the quarter. The returns of the largest holdings during the quarter were Exxaro 30.9% (up 6.7% last quarter), Billiton 24.0 % (15.1%), ArcelorMittal 13.2% (44.3%), Sasol 18.6% (14.6%) and Grindrod 19.1% (-5.9%).

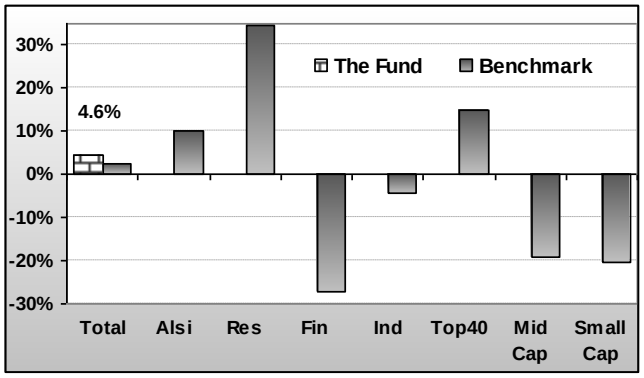
Chart 8: Year-to-date returns to 30 June 2008



The un-annualised year-to-date returns are shown in Chart 8. ***The return of the total Fund was -0.9%*** which can be measured against the return of the Maestro equity benchmark of -1.0% and All share index gain of 6.4%. The influence and weight of the basic materials sector, which rose 32.1% over the period, on the All share index

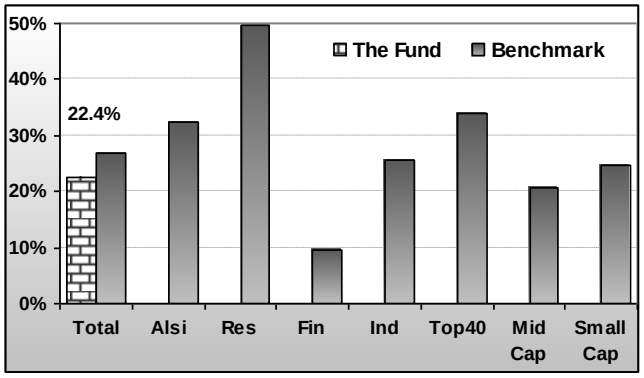
is again evident. The financial and industrial indices *declined* 25.4% and 9.5% respectively over this period, and the mid and small cap indices 19.6% and 22.7%.

Chart 9: Annual returns to 30 June 2008



The annual returns are shown in Chart 9. ***The annual return of the total Fund for the year to 30 June was 4.6%.*** The inflation rate rose 11.7% during this period while the All bond index lost 2.7%. This return can be compared to the Maestro equity benchmark return of 2.6% and All Share Index of 10.1%. The returns of the other major indices are shown in the chart, including the two extremes: the 34.5% (annual) return of the resource sector and the 27.2% *decline* in the financial sector - a difference of 61.7% in one year! The mid cap index declined 19.3% during the period and the small cap index 20.6%. The main detractors from the Fund's returns during the past year were Iliad *down* 57.0%, Mr Price 44.9%, Firstrand 41.2% and Steinhoff 34.2%. The main contributors were Exxaro up 117.2%, Arcelor Mittal 75.0%, Sasol 73.3%, Kumba 70.3%, Billiton 52.1% and Implats 43.1%.

Chart 10: CAR: 3-year period to 30 June 2008



The compound annual return (CAR) of the Fund over the three-year period ended 30 June, shown in Chart 10, ***was 22.4% per annum***; it can be compared to the returns over the same period of the Maestro equity benchmark of 26.8% and the All Share Index's 32.4%. Once again the large difference between the sectors is apparent – the basic materials sector rose 49.8% per annum over *each* of the past three years, while the financial sector could only manage a return of 9.6%. The CARs for the large (Top40), mid and small cap indices to June are 33.9%, 20.8% and 24.6% respectively. Bonds and cash delivered returns of 2.9% and 9.2% respectively over the same period.

Before considering what lies in store, can I draw your attention to the **Maestro Equity Fund June 2006 Quarterly Report,** which you can find on our website, by clicking here**?** I draw your attention to this Report because it provides substantial detail on the Fund's first year in existence – a period in which, despite delivering an annual return of 25.7%, the Fund lagged its peers and the overall market. Its first year was characterised by the start-up period, which saw the receipt of lumpy cash flows while the All Share index surged, only to be followed by a tumultuous period between May and June 2006. The June 2006 Quarterly Report provides all the background to this incredible period in the market, which, ironically, looks rather similar to the current environment – weak financials and industrials, surging resources (+85.3%) - sound familiar? The only difference was that the rand was on the skids – it went from R6.00 to R7.13 in two months. So please take a look at the June 2006 Quarterly Report if you would like more background on why the Fund under-performed during the first year of its existence.

7. What lies in store for investors in the months ahead?

"It seems almost futile to think of forecasts when markets are so volatile and beset by such unprecedented events." That's where we began this section in the March Quarterly Report and I'm afraid it's where we have to begin this Report as well. Markets tried in vain to overcome the negative factors midway through the June quarter; at the time of writing markets are again heading sharply lower. In this section I will share Maestro's view of the remainder of the year and identify some of the risk factors expected to continue bugging the markets. I will also provide reasons why **we do not believe selling out of local equity investments at current levels makes any sense**. Finally, without going into too much detail, I will suggest possible catalysts for a turnaround in markets although I'm sure you will appreciate the difficulty implicit in this task. More than anything else it is an exercise in creative thinking and an invitation to you to join in our thinking as to what the future holds and what will arrest the current decline in equity markets.

During the nine months to end-March the markets were beset by a **global credit crisis**. The latter continues to severely disrupt investment markets, but as though that weren't enough to contend with markets now face a second crisis, namely a **global energy crisis**. Although commodity and food prices have risen strongly none of their gains have been as dramatic as the rise in the price

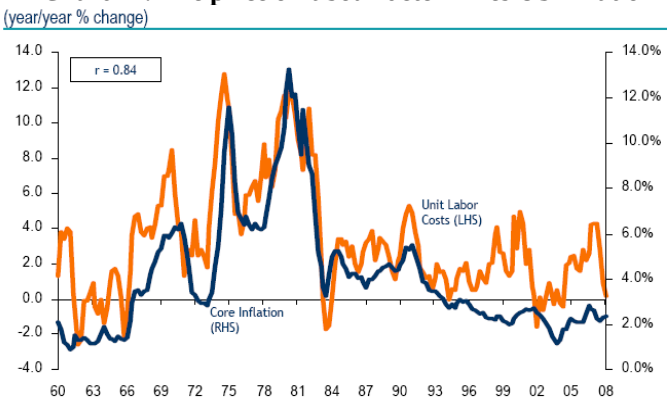
of oil. Politicians, the eternal "Johnny-come-lately's" to the party, have begun investigating the role of speculators and derivative players in the rise of the oil price, but we are of the opinion that this suggestion is little more than an opportunistic attempt to find a scapegoat. It displays a shallow understanding of the oil market. The latter is so multi-faceted that to seek one or even two reasons for the rise in oil is a waste of time, particularly for countries like South Africa, which are very dependent on imported oil for their survival. Our view is simple: the price of oil will probably go higher still and is likely to stay high for a lot longer than most expect. The days of an oil price below $100 are behind us and are unlikely to see the light of day again for a couple of years.

So then, beset by two global crises, what can we expect in the coming quarters? In formulating the answer, the following views of ours are worth noting:

- *Continuation of the credit crisis*: despite their admirable efforts we think regulators and US ones in particular have significantly under-estimated the effects of the global credit crisis on the world at large and the US economy and consumer in particular. The effects of the crisis have been devastating and have wiped hundreds of billions of dollars off banks' balance sheets and their ability to provide credit to worthy customers. We are not alone in thinking that there may be more billions to write off, and that excludes the recapitalization of the US government sponsored enterprises of Fannie Mae and Freddie Mac, which are the latest source of concern and instability in the market. To place the latter in perspective it is worth noting that the latter own or guarantee a combined $5.2 trillion in US home loans – more than 40% of all outstanding home loans in the US. We are not suggesting that their entire home loan books are of suspect quality, but it gives you an idea of the sums involved. And in case you wondered what the market thinks of the situation the prices of both companies have fallen more than 80% so far this year. Although their loans carry implicit government guarantees the companies are privately owned, a large part of which is in foreign hands. In summary, the global credit crisis will continue for a while yet, under-mining investor confidence and severely hampering the normal functioning of the economy and any incipient recovery that might otherwise occur.
- *Continuation of the energy crisis*: here too, the news is not good. It is not too far-fetched to expect the oil price to reach $200 a barrel in due course. While the causes of the high price are many it is fair to say there is just not enough oil to satisfy demand. Alternatively, there is insufficient of the right type of oil to satisfy demand. While we agree that the higher price will eventually affect demand it is worth remembering that in the areas of greatest demand such as China, India and Malaysia, petrol subsidies are still alive and well, meaning that the full effects of the higher oil price on the consumer have not really been felt in the areas of greatest demand. In addition it is clear that over the past few decades insufficient effort has been devoted to finding more oil, added to which are environmental concerns that are being accorded an increasing priority in decisions relating to oil and its use. The world has under-estimated the effects of years of strong growth in emerging markets on the demand for oil. The additional demand for oil from this source is not going to dissipate in the future, leading us to believe that the higher oil price is to a large extent a structural problem. Sadly, there still seem to be a number of nations and parties who believe the best way to settle disputes is by military means – the US, Israel, Iran and Nigeria immediately come to mind - most of which are situated in oil-sensitive regions. We are particularly concerned by the high-profile spat between Israel and Iran; just imagine for a moment what the oil price would be if one of those nations launches an attack on the other? Need we say more?
- *Rising inflation*: we suspect that rising inflation and food prices in particular are likely to remain high on the agenda and will continue to trouble markets for some time to come. Inflation in China and India are particularly worrisome; we will be watching it, and the response of the respective governments, closely. Action already taken by governments as well as the hope for more normal weather patterns, however, will alleviate the situation to some extent. It remains a disruptive factor, though, not entirely within anyone's control, so it remains on our list of risk factors.
- *US inflation*: one exception to our concern of rising inflation is US inflation. Space precludes a detailed discussion of the prospects for US inflation, but it is our considered view that *US inflation will not rise dramatically*. In fact disinflation may be more of a problem as rising productivity (due to lower unit labour costs) and the effects of the credit crisis take hold. Although this seems strange given the sharp rises in food and energy prices one way of thinking about US inflation is the following: seven years into the commodity bull market in the 1970s core and headline inflation was more than 14.0%. This time around i.e. seven years into the current commodity bull market, core and headline inflation are only 2.4% and 5.0% respectively. The point is that a number of other items in the inflation basket have declined substantially in price and it is largely their influence that will prevent US inflation from rising dramatically in the coming years. The recent

rise in inflation had more to do with developments in the global economy and supply constraints than with a rise in US labour costs or an over-heated economy. More importantly, the US consumer is fighting dual headwinds of deflating house prices and a contraction in the availability in credit. To place the size and effect of the latter on inflation into perspective, the value of US equities and real estate is $40 trillion, almost three year's worth of US GDP. Moreover, there is a large amount of (deflationary) slack building up in the US economy: unemployment has risen from 4.4% to 5.5% and capacity utilization has fallen from 80.1% to 77.5% – hardly the stuff inflation is made of. Economists refer to this as the "output gap" i.e. the amount of "latent potential" inherent in an economy. The output gap in the US is estimated to be around 2.0% at present and Merrill Lynch forecast it to increase to 4.0% by the end of 2009. If they are correct, it will be the largest output gap in the past 25 years – once again, hardly an inflationary environment. Chart 11 depicts the relationship between core inflation and unit labour costs. There is an 84.0% correlation between US labour costs and core inflation - labour costs explain 84% of movements in inflation, which is more than triple the correlation between commodity prices (not shown on the chart) and inflation. Note the recent trend in labour costs: they have declined in the past year to the point where they are now flat year-on-year.

Chart 11: The price of labour determines US inflation



Source: Merrill Lynch

- *Global currencies*: why a view on US inflation is important is that it holds the key to the future direction of US interest rates and hence the US dollar. Given our view that inflation in the US is not a problem we consequently also retain our view that US interest rates are not headed higher for some time, which leads us to believe that *the dollar will remain inherently weak*. If our view of a weak dollar is correct it bodes ill for the price of commodities and oil in particular, given that they are all dollar-denominated.
- *Global interest rate developments*: while on the topic of global interest rates, it seems likely that the ECB will retain an upward bias to interest rates, which will in turn support the euro and undermine the dollar. Similarly the struggle between higher prices (inflation) and declining economic activity will weigh heavily on the Bank of England (BoE) which we believe will lower interest rates in due course as immediate inflation pressures abate. Key to this view is the extent to which central banks believe the rise in prices is permanent; the BoE and the Fed seem to believe that the rise in inflation is temporary while the ECB seems more concerned about a *sustained* rise in inflation which will lead to second round effects and still higher inflation.
- *The US recession*: reverting back to the US economy for a moment we continue to believe that the US economy moved into a recession at the beginning of this year. For the technically-minded amongst us there are four conditions that are examined in order to determine a recession. They are firstly real sales in manufacturing and retail (these peaked in October last year); secondly, employment (which peaked in December); thirdly industrial production (which peaked in January) and finally real personal income excluding government transfers (which peaked in February). It is clear to us therefore that the US economy is by now well-entrenched in a recession. We further believe the recession will last longer than expected – we do not subscribe to the "short, sharp" so-called "V-shaped" recession view. If our view is correct the level of *global* economic activity will continue to slow although we still hold that growth in the large emerging markets such as China and India, driven by domestic demand more than anything else, should prevent the world from moving into a recession. That is not to say that growth in those countries will not slow, we just think growth will be sufficiently robust to prevent the world economy from sliding into a recession.
- *The state of the US consumer*: we have often expressed our concern about the state of the US consumer and believe it is worth repeating here. There is more than sufficient evidence to prove that the US consumer has "run out of credit," having "run out of money" some time before that. Now his balance sheet i.e. the assets which he leveraged so much during the past two decades is under threat. Equity markets have declined sharply and house prices are in steep decline. In many cases market value of his debt is substantially greater than the market value of the assets on which that debt is based – a so-called "negative-equity" situation. The savings rate continues to be virtually non-existent and unemployment is rising. Food and energy prices are rising and wage growth is flat and

consumer confidence is at its lowest level since 1992 – refer to Chart 13.

Chart 13: US consumer confidence
Shaded areas represent recessions

Source: Merrill Lynch

- There have only been three other times since the index began when consumer confidence was lower (1974, 1980 and 1990) and all of those times involved recessions. Consumer expectations, a sub-index of the confidence index, is at its lowest level since the series began in 1968. That's how bad it is; no matter which way you look at it, prospects facing the US consumer, who for so long was the mainstay on the global economy, look bleak.
- *The SA economy*: during the past quarter a number of market commentators were quoted as saying that the SA economy was heading for a recession. We think this is an exaggeration and hold the view that *the SA economy is not heading for a recession*. Don't get me wrong – economic activity in South African is slowing sharply, particularly the activity and confidence levels of the consumer. However, despite his or her importance there is more to the economy than just the consumer. We have often drawn attention to the hundreds of billions of rand's worth of infrastructural investment that government (the public sector) has already committed itself to, to which can be added an even greater amount of investment by the private sector. This injection of activity and capital has to be added to the economic pie and should be more than sufficient to carry us through the hard times facing the rest of the world.

  But *economic growth* is not the only important criterion to consider. In short, our view of the most important factors is as follows: *inflation* will continue to rise and bring with it upward pressure on local *interest rates* (despite the current debate about the re-weighting of the CPI basket). This should alleviate some pressure on the *rand*, which we are already seeing, but we are nervous about the currency's behaviour as we approach next year's election and the negative news flow surrounding the possible "Zuma trial" and all that goes with it. The rand remains inherently vulnerable due to the large and unavoidable current account deficit; its vulnerability may become more pronounced if and when global investors begin to believe that SA interest rates are no longer headed higher.
- *Valuation levels in the SA equity market*: one of the most frustrating aspects of the past quarter has been to see a "cheap" market get even cheaper by the day due to ongoing share price declines. We have commented on this aspect of the market for some time now and retain our humble view that *the market currently offers tremendous long-term value and represents a wonderful long-term entry point*. That said, experience has taught us that under-valued markets can not only stay under-valued for a long time but can become even more under-valued. So just because markets are inexpensive right now doesn't mean that they are going to rise any time soon or that they won't continue to decline further. I'm sure you can understand why this is such a frustrating time for investment managers! I have tried, in Table 2 below, to give a couple of examples of just how cheap some shares are. Space precludes a more thorough analysis of your entire portfolio, but suffice is to say that most if not all of the companies in which you are invested face reasonable if not above-average earnings prospects, have strong cash flows and have sufficiently robust balance sheets to tide them through the prevailing tough economic conditions. In addition many of the companies have recently confirmed as much by issuing very positive trading statements, yet this has not stopped the market from punishing their share prices even more. A careful analysis of the Table will hopefully help you understand why we are of the view that it does not make sense to sell out of the equity market in general and your current equity investments in particular at these levels. The market is currently being driven by fear and sentiment and not by any reason or sound judgment. Admittedly it is stressful and rather unprofitable to sit and watch one's value declining by the day, but it is also true that to time entry and exit into and out of markets that are so volatile is a very risky thing to do. And of course, in most cases the tax consequences of resorting to this trading behaviour preclude one from actively trying to "time" or trade the market. Maestro's views on the companies in which it invests its clients' funds are based on long-term, valuation criteria and as such we have tried as best possible to maintain this disposition despite the tumbling markets.

Table 2: Examples of the value on the SA equity market

Company	Price	Fwd PE ratio	Fwd Div yield	12-month peak to trough change	5-year Compound annual growth (CAGR) rate in	
	(c)	(x)	(%)	(%)	HEPS (%)	DPS (%)
Abil	2685	8.1	10.0	-40.9	14	32
Firstrand	1471	6.1	7.1	-48.3	19.3	23.7
Investec	5030	7.2	7.0	-57.7	46.0*	21.1*
Digicore	550	10.0	3.0	-52.4	48.2	48.0
Dawn	1125	7.5#	1.8	-55.7	42.0	44.0
Iliad	785	4.8	8.9	-64.6	23.0	16.0
Grindrod	2200	5.5#	5.4	-44.6	49.7	57.7
Group 5	4245	11.0#	2.7	-51.2	23.9	18.1
Mr Price	1730	7.2	7.4	-51.4	26.0	36.0
Arcelor Mittal	20000	6.9	4.9	-28.3	87.6*	54.7*
Billiton	24617	5.9	2.2	-25.8	66.3*	34.2*
Kumba	21980	8.2	9.5	-43.0	N/A	N/A

* 4-year CAGR
# Confirmed in recent trading statement

In closing, what are we looking for as potential catalysts to arrest the current decline in global markets? Clearly, this is a very risky exercise, but a useful one nonetheless which can inform us about what action we should be taking now and what catalysts we should be looking out for. I would encourage you to also give some thought to what these factors may be. Here is a stab at what some of them might be; please treat them with a great deal of caution – *our view remains that markets are likely to remain weak and volatile for some time to come*.

- *Valuation levels:* this consideration is more applicable to the SA equity market than overseas markets; the idea is basically that investors will eventually see the value in the market and stop selling, irrespective of what the prevailing conditions may be. This may sound rather hopeful but one can assess on a factual and historical basis i.e. devoid of sentiment, where markets are valued on the basis of their past ratings; by all accounts the SA market in particular is currently under-valued relative to where it has traded historically. Although the consideration of "value" as a determinant of market movements will be important when assessing how much further prices decline, under the current traumatic market conditions it is unlikely to play a *major* role in turning markets around. One or more of the following factors may be more influential.
- *Certainty within the global financial crisis*: Seeing that the global credit crisis started the rot in July last year, it is not unreasonable to look to this event when searching for a reprieve from the current bear market. When you dig deeper and realize how bad the credit crisis is, what the consequences for the US economy are and consider the extent of the decimation of a large part of the global banking sector that has taken place then you will understand why until such time as this crisis abates or at least stops getting worse, markets are unlikely to stop declining. Whether it be in the form of government intervention or central bank action, or some rescue from sovereign wealth funds (SWF), the global credit crisis will have to be resolved in one form or another before the markets stabilize.
- *A stable or rising dollar*: the weak dollar is a large part of the problem at the moment and a large determinant of many of the woes in various markets at present. The weak dollar is adding to the upward pressure on energy (especially oil) and food prices at present and is undermining global sentiment in financial markets. Unfortunately there is no "quick fix" for the dollar on the horizon, no matter how much jaw-boning the politicians undertake. As we discussed above, the interest rate and economic outlook doesn't bode well for a strong dollar either. We are looking for a firmer dollar, or at least for the dollar to arrest its current decline against most other currencies, as a precursor for a healthier market.
- *A cessation in the rise of the oil price*: this factor is rather obvious, but you should see it in the light of the pervasive effects of a rising oil price throughout the global economy. We think the days of "cheap oil" are something of the past, but at least the oil price needs to stop rising before markets will settle down. This will, in turn, alleviate some of the concern about rising inflation, which will then take some of the heat off interest rates and allow the markets to stabilize.
- *The arrest of rising food prices*: similarly, when food prices stop rising so fast, central bankers will move from the front pages and headlines of newspapers to somewhere less noticeable. The upward pressure on global interest rates will ease, which will in turn provide some breathing space for the markets. In case this sounds rather hopeful once again, remember that inflation measures the *rate of change*, most often expressed on an annual basis, of price increases. Thus food prices do not need to stop rising, they simply need to not rise by as much for the *rate* of inflation to decline. Given that some of the factors that caused food prices to rise sharply recently are once-off and weather-related, there is reason to hope that they will not recur and therefore that some relief might be in the offing.

8. Closing remarks

I would be lying if I said the current market conditions are not testing our views and are not given us a lot of headaches. They are very stressful and not very enjoyable. But more than anything else, they are forcing us "back to basics" and getting us to examine our views to see if they are indeed logical and fundamentally based. Time will tell whether or not they prove to be correct.

As you well know, equity investment is not without its risks. Markets are currently experiencing significant headwinds but we have also "been around long enough" to feel that it is worth "keeping the faith" and staying the course.

The longer-term index returns reflected in this Report provide sufficient evidence of the merits of long-term investment, despite temporary and unenjoyable periods of equity weakness. As much as we find the current markets uncomfortable we will continue to be conservative in our management of the Fund and will seek out and retain investments we believe offer unusual value right now and which will lead to decent long-term returns in the years to come.

Please feel free at any stage to contact either David or I about the portfolio. We remain at your disposal at all times. We look forward to being of further service to you throughout the remainder of the year.

Andre Joubert
24 July 2008