MAESTRO
Equity Fund

PRESCIENT
MANAGEMENT COMPANY

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.

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 Management, 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 Fund 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% and the annual investment management fee is 1.75%. The *annual* total expense ratio (TER) for the past year in respect of class A was 2.03%.

Income Distribution (annually)
29.02 cents per unit
31 March 2012

FUND SIZE: R 83 682 501

MANAGEMENT COMPANY
Prescient Management Company Ltd
Box 31142, Tokai, 7945

TRUSTEE AND AUDITOR
Trustee: Nedbank Limited
Auditor: KPMG Inc.

PORTFOLIO MANAGER
Maestro Investment Management (Pty) Ltd

ENQUIRIES
Maestro Investment Management
Box 1289
CAPE TOWN
8000
Phone: 021 674 9220
Fax: 021 674 3209
Email: equityfund@maestroinvestment.co.za

The Maestro Equity Fund

Quarterly report for the period ended

30 September 2012

1. Introduction

This Report focuses on the investment activities of the Maestro Equity Fund during the past quarter 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 - the 2012 September quarter* which is included at the bottom of this report whereby we discuss in detail the market activity during the quarter.

2. The investment position of the Fund

The Fund's sector allocation is shown in Chart 1. Exposure to the resource sector totalled 22.1% of the Fund, down from 27.0% in June. Financial exposure rose 0.9% to 14.0% and industrial exposure increased 0.2% to 52.9%. Cash represented 11.0% of the Fund, up from the 7.2% at the end of June.

Chart 1: Asset allocation at 30 September 2012

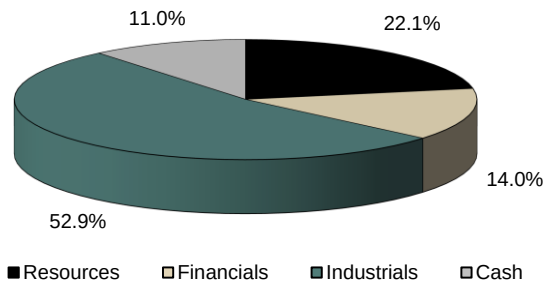
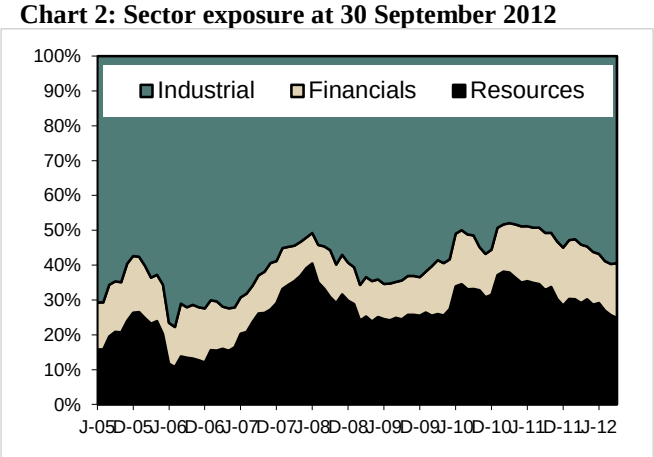


Chart 2 depicts the historical allocation to the three major sectors of the equity market, expressed as a percentage of the equity portion of the Fund.

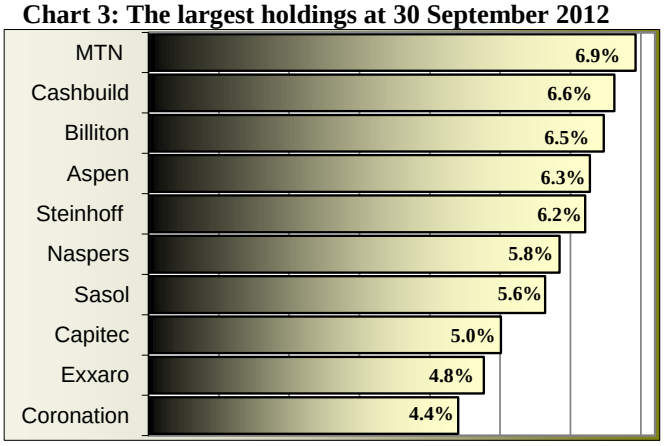
Chart 2: Sector exposure at 30 September 2012



3. The largest equity holdings

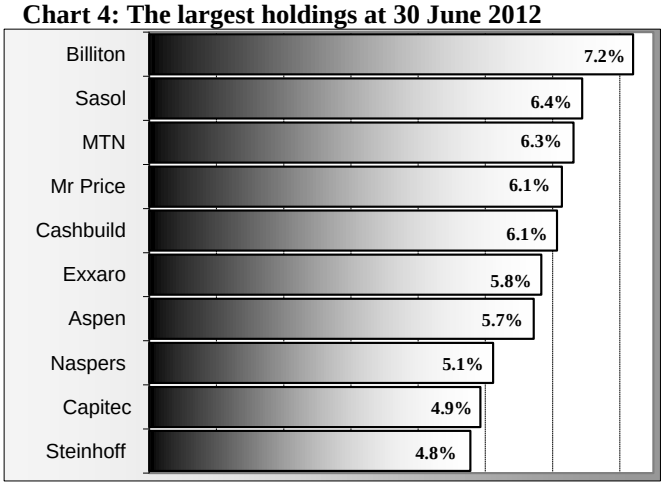
The largest holdings at 30 September are listed in Chart 3, expressed as a percentage of the equity portfolio.

Chart 3: The largest holdings at 30 September 2012



The largest holdings at the end of June are listed in Chart 4. During the quarter Coronation replaced Mr Price in the top 10 holdings of the Fund. At the end of September there were 29 counters in the Fund, unchanged from the end of June. The ten largest holdings constituted 58.2% of the Fund down from 58.5% in June.

Chart 4: The largest holdings at 30 June 2012



4. Recent activity on the Fund

The investment objective on this Fund is to *achieve long-term growth through the assumption of moderate risk.* We would emphasise the "long-term" aspect of this objective; we are confident that the companies in which the Fund is invested will deliver long-term capital growth together with a steady increase in dividends over time.

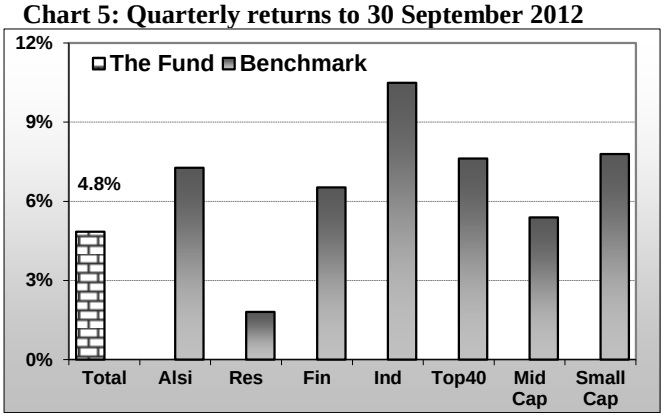
There was a fair amount of activity within the Fund during the quarter as some of the Fund's largest holdings were trimmed and the newer holdings were added to. Last quarter we introduced new holdings in the form of the asset management company, Prescient Limited and the Information, Communication and Technology (ICT) provider, Pinnacle Technology Holdings. Both of these holdings were added to during the September quarter.

Due to the exceptionally strong performance of Mr Price so far this year, the Fund reduced its holding in the company in an attempt lock in some profits from the gains. The Fund also reduced its resource exposure by trimming the holdings in Billiton and Sasol.

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 September quarter was 4.8%***.

Chart 5: Quarterly returns to 30 September 2012



The Fund's return can be compared to the All share index (Alsi) return of 7.3%. 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. I also encourage you to read the extensive commentary on the market movements during the quarter in, *Market commentary - the 2012 September quarter* which is included at the bottom of this report.

You will see from the market commentary that the September quarter saw strong gains across all types of risk assets. You will remember that in the June quarter investors ran for cover in perceived safe-haven assets such as government bonds in the face of a weakening global economy and more bad news out of Europe. Risk assets such as emerging market equities and commodities were sold off sharply. The "risk-off" theme changed in the September quarter primarily due to the monetary stimulus announcements by the world's largest central banks.

In the market commentary we expound in detail on the profound effect this quantitative easing (QE) announced by the US Fed, ECB, BoE, BoJ and the PBoC had on the markets. In short, the environment of heightened

liquidity caused by the QE led to investors flooding into equities and commodities. This type of market movements in times of QE is what we have come to expect over the last few years since the financial crisis.

The quarter also provided further indication that the world economy is slowing. Evidence to this fact include the most recent US GDP data which showed growth moderated in the second quarter, easing to an annualised 1.3% from 2.0% in the previous quarter. We also saw consensus market forecasts for the Chinese economy being downgraded from a previously expected 2012 GDP growth rate of around 8.4%, down to 7.7%. The German economy, susceptible to depressed economic conditions in the rest of Europe and in China does not look like it is escaping the trend of slower economic growth. Their government has downgraded its 2013 GDP growth forecast to 1.0% (from a previous 1.6% forecast in April), with the finance ministry saying that "uncertainty about the ability for policy makers to curtail the crisis has resulted in companies postponing investment."

One more notable economic feature in the September quarter was the release of further data showing that global manufacturing is slowing. This is most noticeable when looking at the recent trends in the Purchasing Managers Indices (PMI) of the world's largest economies. Almost every country surveyed indicated a below 50 reading in their PMIs (below 50 indicates a contraction in manufacturing and above 50 an expansion) during the quarter. The JP Morgan Global PMI was 48.9 in September – the fourth successive month below the 50 mark.

With that by way of a macro economic backdrop it is interesting to note which sectors drove the market higher during the quarter. Even with investors' increased appetite for risk, a generally weaker rand and strong commodity prices, the resource index was again the laggard in the local market. The index's 1.8% gain was far outstripped by another very impressive quarterly performance by the financial and industrial index, gaining 6.5% and 10.5% respectively. It is extraordinary to see the divergence in the various indices' returns continue to widen.

The lack of investors' interest in the resource sector can be attributed to a few factors. Firstly, investors have preferred to own the physical metal (i.e. gold, platinum, copper etc.) rather than owning the equity (i.e. the miner). Problems with production, labour unrest and rising electricity costs at many South African mines have been causes for renewed caution by investors when thinking of investing in the sector. Also, with global growth moderating, many investors may believe that the sharp bounce in commodity prices (see charts the market commentary) is only a short term reaction to quantitative easing and unsustainable in a world of slowing growth. All these factors have led to another quarter of the resource index lagging the industrial and financial indices.

What is not seen in Chart 5 is the performance across size spectrum as the small-caps (returning 7.8% for the quarter) outperformed their larger cap peers, the Top40 (7.6%) and mid-caps (5.4%).

The returns excluding dividends of the largest holdings in the portfolio during the quarter were as follows: MTN rose 13.7% (it declined 6.1% in the June quarter), Cashbuild 13.1% (8.7%), Billiton 9.7% (-0.3%), Aspen 13.6% (6.2%), Steinhoff 5.8% (-10.4%), Naspers 18.4% (0.9%), Sasol 8.7% (-7.6%), Capitec 5.4% (3.7%), Exxaro -15.3% (-4.1%) and Coronation 12.0% (-2.9%). Other holdings in the Fund which posted strong quarterly returns included those in Pinnacle Technology, which rose 13.4% during the quarter, Richemont 11.6%, Tiger Brands 11.5%, City Lodge 8.2% and Blue Label Telecoms 7.3%. On a negative note, the laggards in the portfolio were Metmar which declined 26.7%, Anglos 9.8% and African Bank 9.0%.

Chart 6: Year to date returns to 30 September 2012

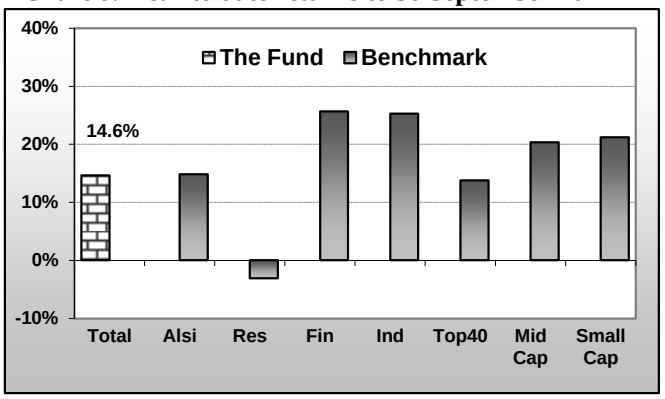
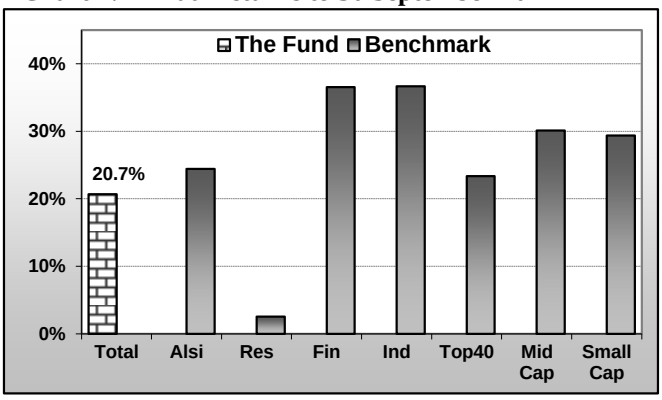


Chart 6 depicts the returns for the year-to-date. ***The un-annualised return on the total Fund during the 9-month period to end-September was 14.6%*** compared to the All Share Index's 14.8%. The mid and small cap indices rose 20.3% and 21.2%. The chart depicts clearly the largest casualty over this period; the basic materials index fell 3.1% versus the 25.3% gain in the industrial index and the 25.6% rise in financials.

The annual returns to end-September are shown in Chart 7. ***The annual return of the total Fund for the year to September was 20.7%***. Inflation rose 5.0% over the year and the All bond index rose 17.0%.

Chart 7: Annual returns to 30 September 2012

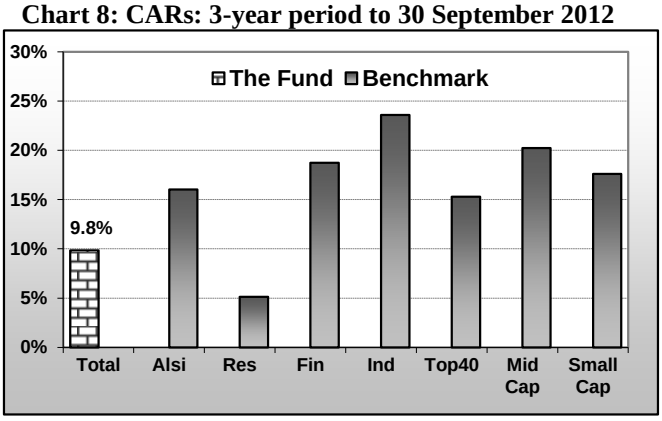


The Fund's annual return can be compared with the All share index returns of 24.4%. Putting the industrial and financial sector's outperformance into perspective; over the past year industrials and financials are up 36.5% versus a gain of 2.5% for the resources sector. Not shown in the chart above are the annual returns of large, mid and small cap index, which rose 23.4%, 30.1% and 29.4% respectively.

With the above as background, it should not surprise you that within the Fund, resource counters dominated the worst performers while industrials were the best performers. Onto specifics, the main detractors from the Fund over the past year were Metmar which declined 22.5%, Anglos 11.0%, Exxaro 5.6% and Grindrod 5.4%. On a more positive note Mr Price rose 87.2%, Aspen 56.7%, Coronation 55.0%, Cashbuild 50.6% and Naspers 46.7%. These returns exclude dividends i.e. the changes reflect only the share price movements.

The compound annual return (CAR) of the Fund over the three-year period to September 2012, shown in Chart 8, ***was 9.8%*** and can be compared to the return over the same period of the All Share Index's 16.0%.

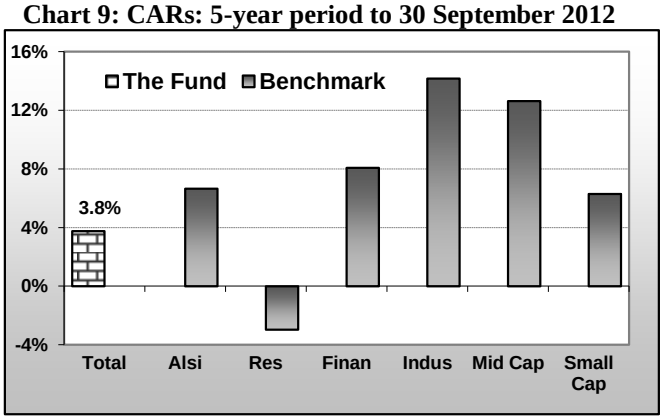
Chart 8: CARs: 3-year period to 30 September 2012



It is clear from Chart 8 which sectors have driven the market higher over the past three years. Across the market cap spectrum, it will come as no surprise that the large cap index lagged the mid and small cap indices with returns of 15.3%, 20.2% and 17.6% respectively. The respective CARs for the All Bond index and cash over this period were 12.7% and 6.2%.

Chart 9 depicts the Fund's CARs for the five-year period to 30 September 2012. ***The compound annual return*** (CAR) ***of the Fund over the five-year period to September was 3.8% per annum*** compared to the All share index return of 6.6%. At the risk of stating the obvious, we will point out again how the industrial index has outperformed all other sectors. Industrials' compound annual return over the five-year period was 14.2% while financials and resources returned 8.1% and -3.0% respectively over the same period. The 5-year CARs for the large, mid and small cap indices are 5.8%, 12.6% and 6.3% respectively. The respective CARs for the All Bond index and cash were 10.6% and 8.2% over this period.

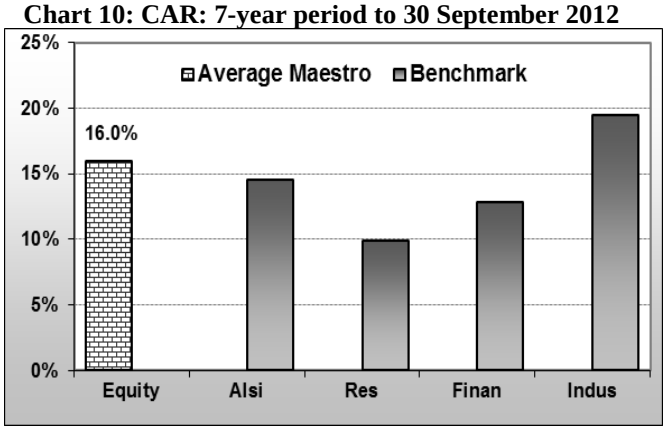
Chart 9: CARs: 5-year period to 30 September 2012



What is not seen in the previous graphs is a trend we have brought to your attention previously, namely the outperformance of the SA equity market relative to developed market returns. Whereas the All share index rose 6.6% per annum over the past five years, the MSCI World index declined 0.8% (in rand terms) per annum. When you consider how low the global returns are, you realise that the SA equity market has been a very profitable investment destination relative to the rest of the world.

Chart 10 lists the compound annual returns (CARs) over a seven-year period. Due to the Fund not having a full seven-year history I list the **average equity return per annum for Maestro's clients over the last seven years which was 16.0%** versus the return over the same period of the All Share Index of 14.5%. In order to place these long-term returns in perspective, as well as those of the SA equity market, consider the CARs of other markets over the past seven years to September: the MSCI World index, which incorporates developed equity markets, rose only 1.3% per annum although the MSCI Emerging market index rose 7.2% per annum.

Chart 10: CAR: 7-year period to 30 September 2012



6. Closing remarks

It is nice to put a strong quarter of gains behind us in what is turning out to be a very profitable year in equity markets. The September quarter saw decisive and substantial action by the world's major central banks in providing further quantitative easing to the global financial system. This has mitigated some of the near-term risks, in particular the risk of a substantial rise in the borrowing costs of highly indebted European countries.

The market has responded favourably to the monetary stimulus this quarter; however there are still a number of key hurdles that the market has to navigate before the end of 2012. At the top of the list are the fast approaching US fiscal cliff and elections, the Politburo election of the next leaders of China and whether Spain is going to ask for a bailout. An unexpected outcome in one of these key hurdles could prove to be very unsettling for the market. Be that as it may, the future is by no means certain, and after the strong rise so far this year in equity markets, we are cautious about the near-term prospects for more significant strength. The markets face a number of near term hurdles which it will have to navigate and which will likely set the tone for the next directional movement.

As we have said before, however, there will always be companies that navigate these uncertainties better than their peers. Even with the strength in the markets this year, there are still attractively valued quality companies in the market. These are companies with strong balance sheets, good management, strong cash flows and good earnings growth prospects. Our task is to search for such companies and invest in them. We will thus continue our conservative management of the Fund and will retain holdings in companies that we believe will lead to respectable returns in the long-term.

Luke Sparks
On behalf of the Maestro team
24 October 2012

Collective Investment Schemes in Securities (CIS) should be considered as medium to long-term investments. The value may go up as well as down and past performance is not necessarily a guide to future performance. CIS are traded at the ruling price and can engage scrip lending and borrowing up to 10% of the market value of the portfolio to bridge insufficient liquidity. A schedule of fees, charges and maximum commissions is available on request. Commission and incentives may be paid and if so, would be included in the overall costs. Different classes of units may apply in a portfolio and are subject to different fees and charges. A fund of funds is a portfolio that invests in portfolios of collective investment schemes, which levy their own charges, which could result in a higher fee structure for these portfolios. A Feeder Fund is a portfolio that, apart from assets in liquid form, consists solely of participatory interests in a single portfolio of a collective investment scheme. Forward pricing is used. Fluctuations or movements in exchange rates may cause the value of any underlying international investments to go up and down. CIS prices are calculated on a net asset basis, which is the total value of all the assets in the portfolio including any income accruals and less any permissible deductions (Brokerage, STT, VAT, Auditor's fees, Bank Charges, Trustee and Custodian fees and the annual Management fee) from the portfolio divided by the number of participatory interests (units) in issue. The Fund's Total Expense Ratio (TER) reflects the percentage of the average Net Asset Value of the portfolio that was incurred as charges, levies and fees related to the management of the portfolio. A higher TER does not necessarily imply a poor return, nor does a low TER imply a good return. The current TER cannot be regarded as an indication of future TER's. During the phase in period TER's do not include information gathered over a full year. Maestro is a member of the Association of Savings and Investments.

MAESTRO

Market commentary – the 2012 September quarter

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

Table 1: Selected returns – equity markets

	Sep quarter (%)	Jun quarter (%)	2012 Year to date	Annual returns (%)
Japan	-1.5	-10.7	4.9	2.0
Hong Kong	7.2	-5.4	13.1	18.5
Germany	12.5	-7.6	22.4	31.2
UK	3.1	-3.4	3.1	12.0
US (S&P500) and large cap	6.5	-3.4	16.7	30.6
S&P Mid cap	5.0	-5.3	12.5	26.6
S&P Small cap	5.1	-3.9	12.8	31.7
MSCI World index	***6.1***	***-5.8***	***10.9***	***18.8***
Brazil	8.9	-15.9	4.3	13.1
Russia	9.3	-19.7	6.8	10.0
India	7.7	-0.2	21.4	14.0
China	-6.3	-1.7	-5.2	-11.6
MSCI Emerging market index	***7.0***	***-10.0***	***9.4***	***13.9***
JSE All share	***7.3***	***1.0***	***14.8***	***24.4***
JSE All share ($)	***6.3***	***-5.2***	***12.4***	***21.2***
Basic materials	1.8	-2.9	-3.1	2.5
Financial	6.5	4.6	25.6	36.5
Industrial	10.5	2.6	25.3	36.7
Gold mining	3.1	-2.2	-14.2	-13.6
Large cap (Top40)	7.6	0.6	13.7	23.4
Mid cap index	5.4	3.2	20.3	30.1
Small cap index	6.2	1.8	19.4	27.5

After a dramatic first half of the year where we saw markets power ahead in the first quarter and then slam on the brakes in the second quarter, most major markets embarked on a steady climb higher during the third quarter of 2012. To be honest, the state of the global economy and the outlook for global growth has not really improved in the last three months. Actually, the economic data releases out of the world's major economies have been to the contrary, but more on this a bit later in the report. If we look at the underlying factors causing the steady upward climb in most equity markets, the monetary stimulus and promises of further monetary stimulus by global central bankers stand out as the most obvious causes.

As shown by Table 1 above, almost all global equity markets produced respectable and, in many cases, outright impressive performances over the third quarter. Emerging markets, which were particularly weak in the second quarter where the "risk-off" trade seemed to dominate, rebounded strongly and outperformed their developed market peers.

The top performer in the developed market universe was Germany, as the Dax rose an impressive 12.5% in the quarter, making it the top performing developed market so far this year (22.4%). The US market also performed strongly, as the S&P rose 6.5% with the world's largest company, Apple (which rose 15.1% over the quarter), driving the index up. The UK put in a steady 3.1% return after outperforming other developed markets in the second quarter. Japan, however, was the noticeable laggard, returning -1.5% for the quarter, predominantly on the back of weaker economic data from China and a strengthening yen. The most notable moves in the emerging market universe were the quarterly performances of Russia, Brazil and India which rose 9.3%, 8.9% and 7.7% respectively. China was the stand out laggard in the emerging market universe, declining 6.3% for the quarter as the Shanghai Composite index fell to the lowest levels since 2009. It is interesting to note that even after the recent strong rally in emerging markets, global fund managers are still significantly underweight their benchmarks in the asset class.

On the whole, emerging markets fared better than developed markets during the quarter. The MSCI emerging market index rose 7.0% compared with the MSCI World index return of 6.1%.

Table 2: Selected returns – bonds, commodities, currencies

	Sep Quarter (%)	Jun Quarter (%)	2012 Year to date	Annual returns (%)
SA All Bond index	5.0	5.2	13.0	17.0
SA Cash	1.4	1.4	4.2	5.6
Barcap Global Agg. Bond index	3.3	0.6	4.8	5.1
Emerging market bonds	6.3	1.7	16.7	13.6
US 10-year bond	0.9	5.8	5.6	4.4
US Corporate bond	4.0	2.4	11.0	9.0
US High yield bond	4.6	1.8	18.9	12.0
Cash (US dollar)	0.0	0.0	0.1	0.1
DJCS Hedge index	1.9	-1.8	1.9	4.5
Brent (Oil)	14.9	-20.4	4.7	9.4
Gold	11.1	-3.9	12.8	9.6
Silver	28.0	-16.5	23.0	13.8
Platinum	16.8	-12.9	23.2	10.4
Palladium	9.4	-9.8	1.9	4.6
Copper	8.7	-10.1	9.0	15.3
Nickel	12.7	-5.9	1.6	1.4
Baltic Dry index	-23.7	7.5	-55.9	-59.7
CRB Commodity index	13.8	-11.1	1.4	3.9
S&P GS Commodity index	17.3	-17.0	3.1	9.7
Euro dollar	1.4	-4.7	-0.9	-4.1
Sterling dollar	3.0	-1.8	3.9	3.7
Swiss franc dollar	-0.7	4.7	0.5	3.5
Rand dollar	-0.9	-6.2	-2.2	-2.6

Arguably the most drastic movements in the markets over the quarter were seen within the commodity space, and more specifically the metals universe. Over the last couple of years, we have become accustom with commodity prices (in particular the base and precious metals) being the short-term standout performers after the announcement of major monetary stimulus by central banks. This quarter is a classic example of this very phenomenon.

The June and September quarterly returns shown in Table 2 highlight the drastic turnaround in the fortunes of commodity prices over the most recent quarter, fuelled by central bank stimulus. The perception of hard commodities and, in particular, precious metals being a "store of value" in times of monetary stimulus saw silver, gold and platinum rally 28.0%, 11.1% and 16.8% over the quarter. The oil price also rebounded from a weak second quarter, rising 14.9% as a result of continued tensions in the Middle East and a very possible strike from Israel on Iran's nuclear facilities.

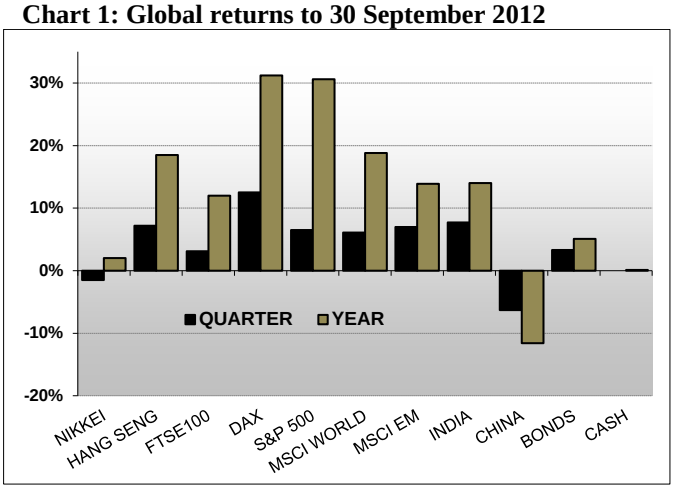
The "risk-on" theme also found its way into the bond market, as emerging market and high yielding US bonds put in impressive performances for the quarter, rising 6.3% and 4.6% respectively. The general trend of the dollar was a weaker one as it declined 1.4%, 3.0% and 2.5% against the euro, pound and yen respectively. Owing to South African specific factors, namely the labour unrest, the rand bucked the general trend of firming emerging market currencies, and extended the second quarter losses by declining 0.9% against the dollar.

Global investment markets

Chart 1 summarises the quarterly and annual returns of the major global equity, bond and cash markets. You can see clearly from this chart that most risk assets have performed exceptionally well in the recent quarter. The annual returns seem to accentuate some of the stark differences we have seen in this quarter's returns. For example, the US and German stock markets have risen 31.7% and 31.2% respectively over the last year, whereas the Japanese market has only risen 2.0% and the Chinese market has *declined* 11.6%! Even though there is a general consensus in the market that the majority of the world's economic growth is going to come through the BRIC countries, i.e. Brazil, Russia, India and China, their equity markets have substantially underperformed their developed market peers over the last year, returning only 13.1%, 10.0%, 14.0% and -11.6% respectively. Emerging markets have underperformed developed markets over the last year as the MSCI emerging market index has returned 13.9% as compared with the MSCI World index return of 18.8%.

The majority of the annual gains in the global bond market came in the most recent quarter as global investors pile into bonds in a search for yield in a world where accommodative monetary policy seems here to stay for a long time.

Chart 1: Global returns to 30 September 2012



As mentioned above, global central bank easing and the expectations of further easing have been some of the key drivers of equity markets over the last year. In an environment of heightened liquidity, equity markets tend to perform well, and this phenomenon dominated markets during the quarter.

While by no means comprehensive, the following were some of the features of the June quarter which caught our attention and we would like to expound further.

- *Central Bank stimulus:* By far, the main feature of the September quarter was the co-ordinated monetary easing by the world's major central banks. The Bank of England was first to act by announcing a third round of quantitative easing in July, with £50bn of asset purchases to be spread over 4 months, taking the total QE programme to £375bn. Next was the European Central Bank (ECB) which announced a sovereign bond buying programme called Outright Monetary Transactions (OMT), ready to buy unlimited amounts of bonds of up to 3 year maturities of countries that request a bailout and fulfil policy conditions.

  As was widely expected, the US Federal Reserve (Fed) launched a 3rd round of QE – announcing purchases of $40bn worth of mortgage-backed securities a month until the unemployment rate outlook improves substantially. We shall touch more on the US employment situation later in the report, but with this kind of strong commitment, it is no wonder that we are hearing the term, "QE infinity" being tossed around in the market. The Fed also extended its commitment to ultra-low interest rates to the middle of 2015 from the end of 2014. The Bank of Japan, which has been adopting a loose monetary policy for the last decade in the effort to fight off deflation, also expanded its asset buying and loan programme by ¥10 trillion to ¥80 trillion, while extending the deadline for the target asset buying by 6 months to December 2013. However, the key policy rate

was maintained in a 0% to 0.1% range. China did not want to be left out of the party as the People's Bank of China also injected a record amount of funds into the market – 290bn renminbi of reverse repos in September.

Chart 2: The US equity market (S&P 500 index)

Source: Saxo Bank

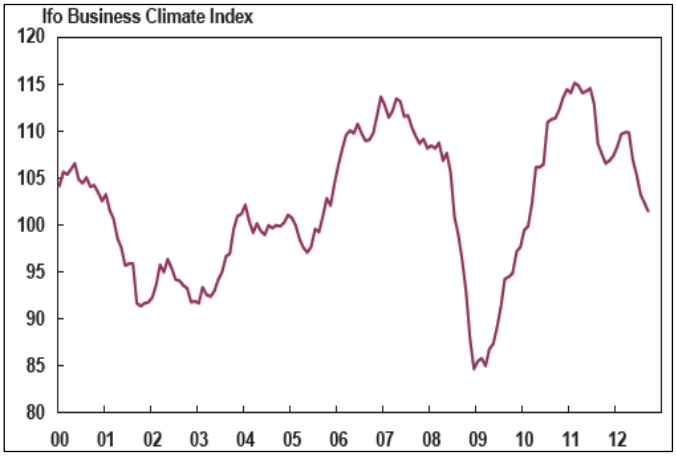
- *The US market:* The US market put in a strong performance in the third quarter (see Chart 2) despite more data being released which continues to point to a slowdown in the economy. An interesting characteristic of the quarter was the exceptionally low volatility in the market. In the last two months we have seen the measure of market volatility (the VIX) fall to a five-year low .The S&P 500 return so far this year of 16.7% has come about with only five daily moves in excess of 2.0%! This is a remarkably low statistic when we compared with 2007, 2008, 2009, 2010 and 2011 which had 14, 53, 55, 21 and 29 greater than 2.0% move days respectively!
- *The US economy slowing down:* This is most notably seen in the recently released US GDP numbers which showed growth moderated in the second quarter, easing to an annualised 1.3% from 2.0% in the previous quarter. Consumers were less optimistic about economic prospects than they had been at the beginning of this year, mainly due to subdued job growth. Arguably the data point which the market focuses most on is the number of new jobs which are added in the US economy each month (non-farm payroll gains). On average 132 000 jobs were added in each month of the third quarter. This is more than the average monthly gain of 67 000 in the second quarter, but is still *far* below what the US needs to make any meaningful dent in the unemployment rate. Apart from the peculiar unemployment print of 7.8% in September (which is mostly a factor of workers leaving the labour force rather than more jobs being added), the unemployment rate has remained sticky between 8.1% and 8.3% since the beginning of 2012. The outlook for the US economy has continued to weaken, overshadowed by global prospects and the so-called 'fiscal cliff'. The Fed has downgraded growth projections further: it now expects US economic growth to be between 1.7% and 2.0% in 2012, slightly lower than the 1.9% to 2.4% projected in June, while growth is expected to be marginally firmer over the next two years before rising above 3.0% only in 2015.
- *The German market:* This quarter's winner in the developed market universe was Germany, as the Dax rose an impressive 12.5% (see Chart 3). The strong performance came on the back of the ECB's announcement of its bond-buying programme aimed at helping reduce borrowing costs of highly indebted peripheral nations in the eurozone. The German Constitutional Court ruling that the European Stability Mechanism (ESM) was legal paved the way for the facility to start operating in October also added to the positive sentiment.

Chart 3: The German equity market (The Dax index)

Source: Saxo Bank

- *The German economy:* More evidence emerged during the quarter that the German economy is taking strain under the fiscal tightening and general weak demand being experienced around the world. Business sentiment has dropped to its lowest level in more than two years, with the German Ifo business climate index touching its lowest level since February 2010 (see Chart 4). To make matters worse, the forward-looking expectations index points to further worsening of business conditions. The German government downgraded its 2013 growth forecast to 1.0% (from a 1.6% forecast in April), with the finance ministry saying that "uncertainty about the ability for policy makers to curtail the crisis has resulted in companies postponing investment." This is further evidence that economic growth is being affected by companies' lack of investment as a result of policy makers' favourite habit of "kicking the can down the road" on key decisions.

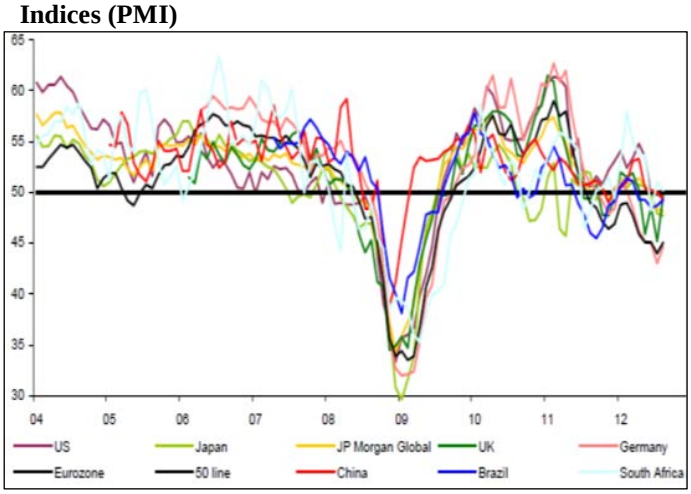
Chart 4: German business conditions weaken



Source: Ifo (Institut für Wirtschaftsforschung)

- *Global manufacturing:* While on the subject of economic growth, global manufacturing conditions continued to deteriorate in response to a slowdown of international trade and weaker domestic demand. This is most noticeable when looking at the recent trends in the Purchasing Managers Indices (PMI) of the world's largest economies. Almost every country surveyed indicated readings below 50 in their PMIs during the quarter; a reading below 50 indicates a contraction in manufacturing and above 50, an expansion. The JP Morgan Global PMI was 48.9 in September, the fourth successive month below the 50 mark. Chart 5 below indicates that, without a doubt, the trend so far this year has been for a weakening in the manufacturing sectors across the globe. This makes the strong rise in the equity markets so far this year quite extraordinary, and we are a bit sceptical as to how much higher we can go without seeing change in the trend of the economic situation on the ground of the world's manufacturing powerhouses.

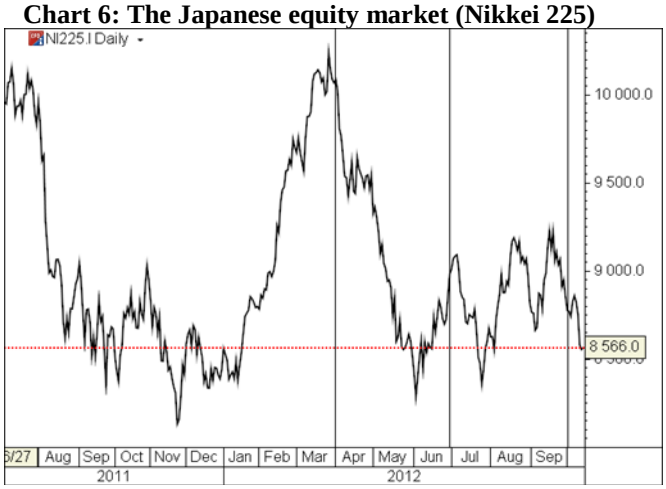
Chart 5: Global manufacturing: Purchasing Manager Indices (PMI)



Source: Bloomberg

- *The decline in Japanese equities:* Table 1 and Chart 6 below show that the Nikkei was the laggard among developed market equities. The Nikkei fell 1.5% in the June quarter compared with its decline of 10.7% in the previous quarter. The Japanese market is dominated by large machinery and vehicle exporters; with the yen firming over the quarter and evidence of China slowing down, it is not surprising that the market lagged behind other developed markets during the quarter.

Chart 6: The Japanese equity market (Nikkei 225)



Source: Saxo Bank

- *The underperformance of Chinese equities and a slowing economy:* China was the notable laggard in the emerging market universe, declining 6.3% for the quarter (the MSCI Emerging Market index rose 7.0%) as the Shanghai Composite index (Chart 7) fell to the lowest levels since early 2009. Over the quarter, the flow of poor economic data continued out of the world's second largest economy and the lack of firm indications of new and significant fiscal and monetary stimulus resulted in further pressure on the Chinese market which has now declined over 40.0% since its 2009 highs.

Chart 7: The Chinese equity market (Shanghai Composite)

Source: The FT

It is worth spending some time on the reasons behind the stark underperformance of the Chinese equity market (which constitutes 18% of the MSCI Emerging Market index). Investors' concerns have predominantly been around data pointing to growth which is slowing substantially in the world's second largest economy and the fear that the government is not going to adequately step in to stimulate demand. Truth be told, the political situation in China is complex, secretive and almost impossible to predict. The reality is that there is much uncertainty around fiscal and monetary easing in China, and a lot depends on which leader is elected in the November meeting of the Politburo Standing Committee of China. At this decennial meeting the next president and prime minister will be elected. The market eagerly awaits as to whether the Politburo elects market-friendly and stimulus-orientated leaders, or more conservative ones. Watch this space!

Chart 8 shows that over the last year and a half Chinese GDP growth has been slowing. Taking a closer look at the GDP expectations, the recent spate of soft Chinese data has not been inspiring confidence in us and the market as a whole. China is now expected by market consensus forecasts to grow at 7.7% in 2012 (previously 8.4% was the expectation). As a result, Chinese companies are only expected to grow earnings on average by 2.7% (from the 10.6% expected at the beginning of the year). It is worth noting that earnings growth estimates for 2013 of 9.4% are already well below their emerging market peers (12.7% for MSCI Emerging Markets).

Chart 8: Chinese GDP growth (q-o-q annualised)

Source: China Statistical Information services

- *Commodity prices:* So we know that growth in China, along with the rest of the world is slowing, but where does this leave commodity prices? Table 2 above and Chart 9 below show clearly that commodity prices have been exceptionally volatile over the last two quarters. The S&P GS Commodity Index shown in Chart 9 ended the third quarter only marginally down from the end of the first quarter of 2012. Commodities historically tend to perform strongly in anticipation and during periods of quantitative easing or similar unconventional monetary stimulus. The second quarter of this year saw commodity prices fly into the headwinds of widespread fears of a global slowdown and few signs of policy makers' willingness to continue to stimulate their economies. Simply put, the rebound of many commodity prices in the third quarter can be attributed to the anticipation and announcement of further quantitative easing which we have commented on above.

Chart 9: The S&P GSCI Commodity index

- *Silver prices:* It is worth showing graphically the extent to which volatility has impacted some commodity prices this year so far. Chart 10 below shows that after a drastic 16.5% drop in the silver price in the second quarter, the price rebounded an impressive 28.0% in the third quarter! It is the belief of many investors that silver and gold are good investments when longer term inflation expectations are rising, such as during times of excessive monetary easing. These "hard assets" are thought to exhibit characteristics such as a "store of value" in times when the dollar is expected to weaken and inflation to rise. This is the predominant reason for the bounce in these asset prices during the quarter.

Chart 10: The silver price ($)

Source: Saxo Bank

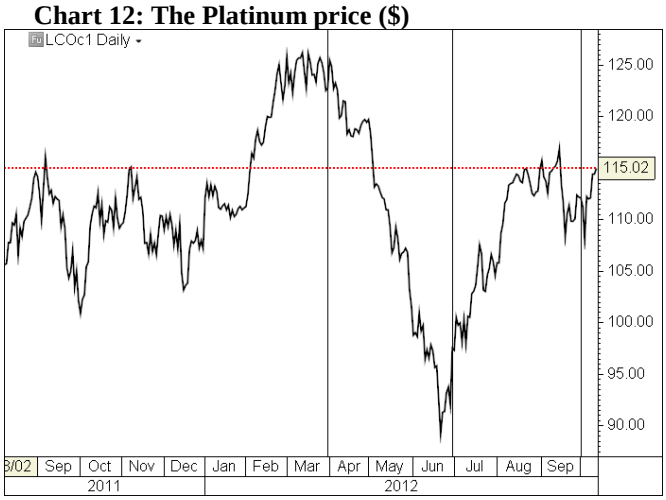
For the reasons mentioned above, the gold price (seen in Chart 11) put in a solid performance, rising 11.1% during the quarter. Although off its September 2011 highs of $1 900, the gold price has risen an impressive 12.8% so far this year.

Chart 11: The gold price ($)

Source: Saxo Bank

- *Platinum price strong but for different reasons:* Although central bank quantitative easing has undoubtedly played a role in the strong quarterly performance in the platinum price, the main driver of the price has been the fears of supply shortages as a result of the wildcat strikes plaguing the industry over the last month. South Africa is the world's largest supplier of the precious metal and the unseasonal strikes have led to a significant loss of production which in turn has caused the platinum price to rise 16.8% in the third quarter after a decline of 12.9% in the second quarter.

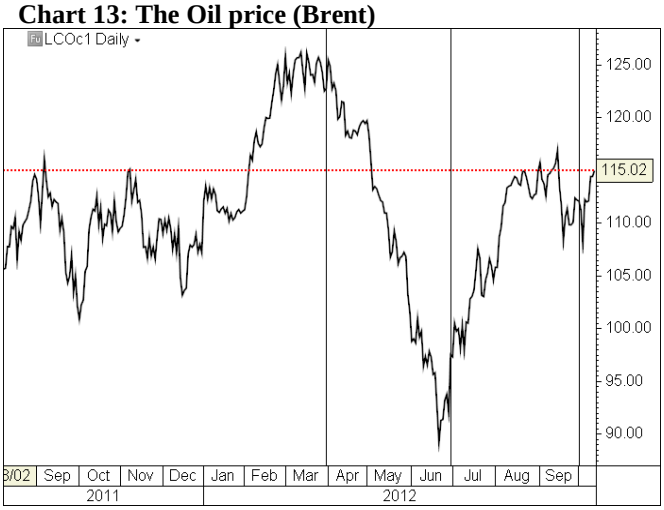
Chart 12: The Platinum price ($)



Source: Saxo Bank

- *Oil prices rebound:* At first glance, it is surprising to see the rebound in the oil price (see Chart 13) given the clear signs that manufacturing is slowing across the globe and the Chinese economy is cooling. There were, however, other factors at play this quarter. The tensions in the Middle East increased in the quarter, particularly the concerns that an attack by Israel on Iranian nuclear facilities could happen before the end of the year. It is also known that US Republican presidential nominee Mitt Romney is an old friend of Israel's prime minister Benjamin Netanyahu. Romney is also performing better of late in the polling data and it is likely that if he is elected next month, the US will take a tougher stance on Iran than under the Obama administration. This is likely to put further pressure on oil prices.

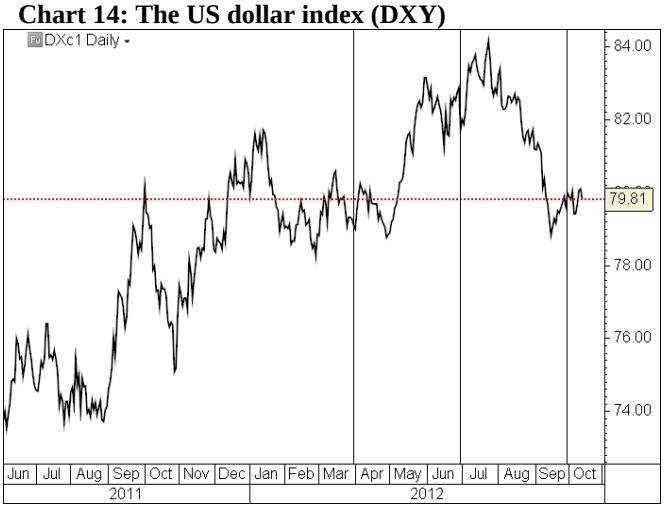
Chart 13: The Oil price (Brent)



Source: Saxo Bank

- *The weaker dollar, typical in a risk-on environment:* The "risk-on" theme created by central bank easing over the quarter was unsurprisingly negative for the dollar which is viewed as a safe haven asset. This is evident when looking at the decline in the US dollar index (Chart 14) which measures the dollar against a basket of currencies of major US trading partners, weighted according to value of trade.

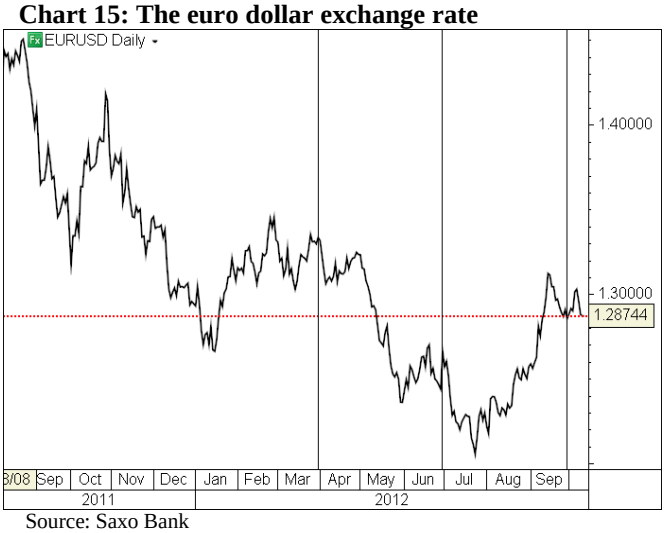
Chart 14: The US dollar index (DXY)



Source: Saxo Bank

The US has been criticized by China and many other emerging market countries for allegedly trying to stimulate economic growth by devaluing the dollar through quantitative easing, thus making their exports more competitive. This is relevant in the light of the fact that the US has been accusing China of manipulating the renminbi in order to stimulate their exports. Unsurprisingly, Ben Bernanke adamantly stresses that this is not in any way the intention of quantitative easing. It is, however, a very positive side effect, obvious to all.

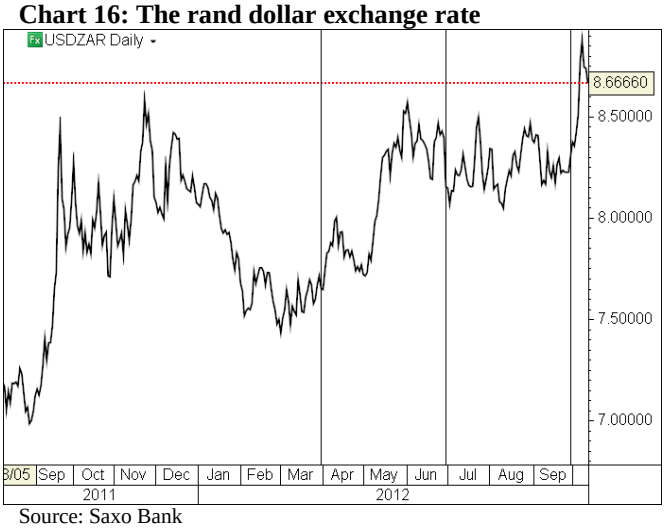
Chart 15: The euro dollar exchange rate



Source: Saxo Bank

- *Euro strength:* After a very weak performance in the 12 months to June, the "risk-on" environment added support for the euro over the quarter. The German Constitutional Court's recognition of the ESM also added to improved sentiment around the currency.

Chart 16: The rand dollar exchange rate

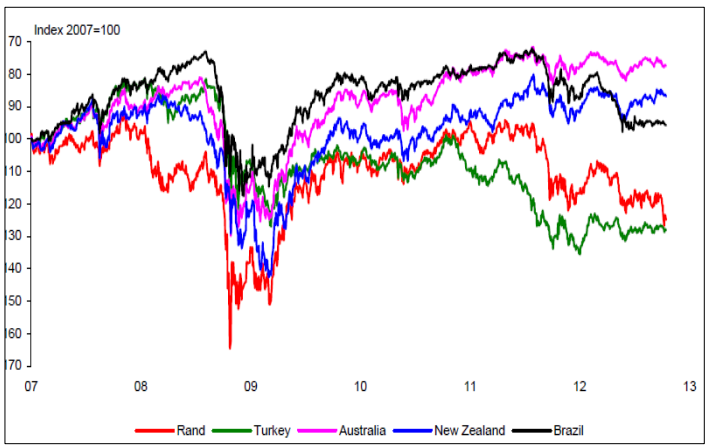


Source: Saxo Bank

- *The rand on a weakening trend:* Moving onto emerging market currencies, Chart 16 shows a disappointing performance by the rand against the dollar over the quarter. Headwinds for the local currency of late include spreading labour strikes in the mining and transport sector, mounting political uncertainty ahead of the ANC's Manguang Leadership Conference in December and a widening current account deficit at 6.4% to GDP in the first quarter of 2012, the widest since the 7.8% in the second quarter of 2008. As is noticeable from Chart 16, the rand has, subsequent to quarter-end, weakened substantially as violent strikes spread across the country, and two ratings agencies downgraded South African government debt. These events are a bitterly disappointing outcome after the triumph of SA's inclusion into Citibank's World Government Bond Index (WGBI) on 1 October. The rebalancing of global funds to accommodate SA's inclusion probably helped to cushion some of the impact of the strikes and the subsequent ratings downgrades on the rand.

Chart 17 shows a longer-term performance of the rand and comparable currencies against the dollar. From the weakness experienced back in the depths of the crisis in 2009 up until half way into 2011, the rand was one of the best performing currencies in the world. The chart shows very clearly that since then, and particularly in the last few months, the rand has underperformed comparable peers as a result of the country specific events mentioned above.

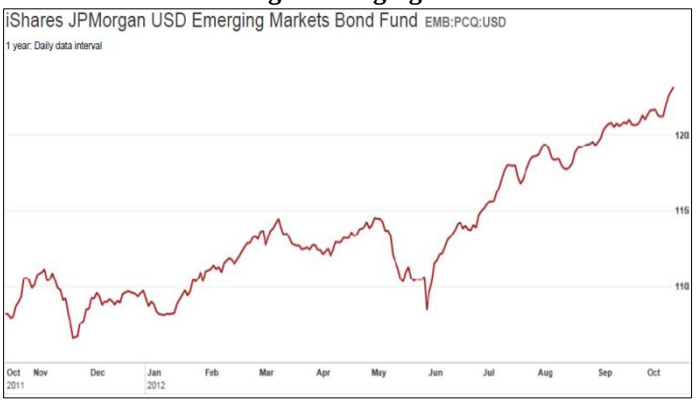
Chart 17: The rand and selected currencies versus the dollar



Source: Reuters and Nedbank calculations

- *Emerging market bonds gained on continued search for yield:* After a lacklustre second quarter in emerging market bonds, yield-seeking global investors flooded into the asset class as more quantitative easing flooded the market and the Fed promised to keep rates low until 2015. With most safe haven AAA-rated government bonds yielding negative real interest rates i.e. the yield is lower than the inflation rate, the attractiveness of higher yielding emerging market bonds led to the asset class returning 6.3% in the quarter (see Chart 18). By way of comparison, the return on the US 10-year government bond was 0.9% in the quarter.

Chart 18: The JP Morgan emerging market bond ETF



Source: The FT

Local investment markets

Turning to South African investment markets Chart 19 depicts the quarterly and annual gains in the major indices for period ended 30 September 2012.

Chart 19: Local returns to 30 September 2012

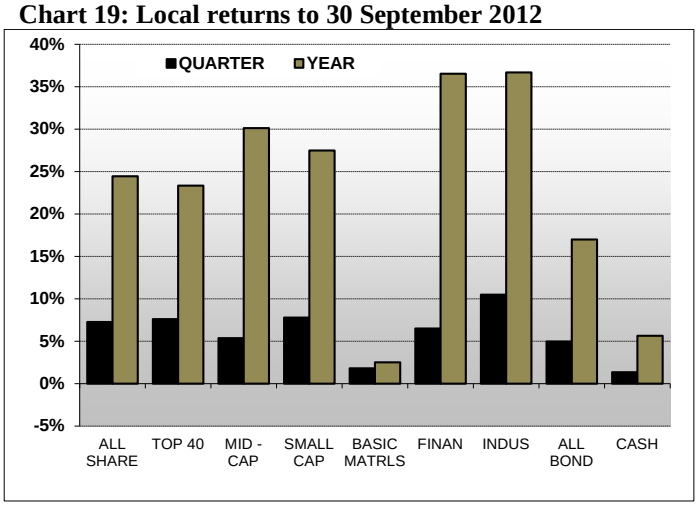


Chart 19 shows that, with the exception of the basic material sector, which continues to lag the industrials and financials sectors, the local market registered a resilient quarterly performance. The drivers behind the All Share index's 7.3% quarterly return were the industrial and financial sectors which rose an impressive 10.5% and 6.5% respectively over the quarter. Despite relatively attractive valuations, a weaker rand and a bounce in commodity prices, the resource sector continued to lag behind the other major indices, gaining only 1.8% over the quarter. The annual numbers look even more astounding with the industrials and financials indices returning 36.7% and 36.5% respectively compared with an unimpressive 2.5% for the year! The All Share index's return in dollars of 6.3% was in line with other emerging markets (MSCI emerging markets index rose 7.0%).

Within the market capitalisation universe, it was a strong quarter for large caps, as the 7.6% increase in the Top40 outpaced the mid and small cap gains of 5.4% and 6.2% respectively. However, mid and small caps have outpaced their large cap peers over the last year, rising 30.1% and 27.5% respectively versus the 23.4% gain for the Top40.

Local economic data released in the quarter showed the South African economy is not immune to a global slowdown. The second quarter GDP growth rose at an annual rate of 3.2% from 2.7% in the first quarter. This number should be treated with caution as the acceleration was mainly due to a rebound in mining output from the strike-inflicted first quarter and not indicative of any underlying resurgence in momentum. More relevant data include the Kagiso Purchasing Managers Index which showed manufacturing activity in the country slowing substantially during the quarter. The index lost four points in September and declined below the key 50 point mark to 46.2. With manufacturing activity now in contractionary territory, the pullback does not bode well for factory sector output in the third quarter. These concerns were reinforced by the business activity index, which fell by a significant 7.6 index points to 43.

There are some areas of the economy which continue to positively surprise us, namely the retail sales figures which are proving to be a lot more resilient than many predicted. In the three months to August, retail sales rose an impressive 3.6% (seasonally adjusted un-annualised). The year-on-year growth to the end of August was 6.4% which shows that the SA consumer is still in reasonable shape.

In an effort to stimulate growth and with inflation within the targeted 3.0% to 6.0% band, the South African Reserve Bank cut interest rates by 0.5% to a new multi decade low. This was much to the surprise of most economists, who expected the rate to remain unchanged. The surprise rate cut was very supportive of the local bond market which rose an impressive 5.0% for the quarter (and 17.0% over the last year). We mentioned in the last quarterly report that the strength in the bond market can largely be attributed to a change in expectations of the South African short-term interest rate outlook. Towards the end of 2011 and the start of 2012, many economists were expecting repo rate hikes of between 1.0% and 2.0% during the 2012 calendar year. As global growth has deteriorated and inflation seems to be under control, many now expect another rate cut, either in November this year or in the first quarter of next year. This has proved supportive of the bond market.

In closing

Markets seemed to carry on climbing the wall of worry this quarter, extending their impressive year-to-date returns with their steady grind higher. With one more quarter to go in the 2012 calendar year and headwinds which include the much talked about US fiscal cliff and a slowing global economy, it is highly likely that most of the major gains of 2012 are behind us already.

As you have often heard us say, markets are moved by the "unknown factors" and not "known factors". The third quarter showed us clear signs that global and local economic growth is moderating, and this fact has become a consensus view in the market, i.e. a known factor. The extent to which global growth slows is dependent on, amongst other things, the outcome of the attempt to avoid the fiscal cliff by the US congress. Another key issue is the extent to which we see clear policies and resolutions in the European Union which although including a strong austerity theme, make some attempt to provide for economic growth. These, amongst other issues are the main unknowns and worries which could prove to be either short-term supports or headwinds to the markets.

Other than probably the two most important hurdles which the markets face in the shorter term mentioned above, there are some other key issues to watch out for which will likely move markets through the end of 2012 and into 2013. As discussed in detail in this report, global manufacturing has been weakening for most of the world's manufacturing powerhouses this year. If this trend continues for an extended period of time, we are unlikely to see markets continue their strong performance seen this year and into 2013.

There also remains a fair amount of uncertainty surrounding the European debt situation and, in particular, the request for a bailout by Spain. It is clear to most people in the market that Spain needs to request funds from the ESM to meet its financial obligations. What we have seen of late, however, is the prime minister, Mariano Rajoy, seeming to be playing a game of chicken with markets by putting off the request. A bailout request would mean that the ECB can start buying Spanish bonds in the attempt to lower their borrowing costs. The nearer term danger for the market is that Spain continues to delay the request, which will likely see traders aggressively sell their bonds. This would lead to an increase in Spanish borrowing costs and would likely worsen the debt crisis in Europe and negatively affect markets. This is not our base case scenario; however it is definitely one of the risks on our radar screen. A bailout request by Spain and more certainty around effective and "growth accommodative" policies in other indebted European countries are likely to be supportive of equity markets.

One last factor that I would like to mention and which on a medium to longer-term basis is likely to be supportive of equity markets, is the relative underweight positioning in equities as an asset class by many retail and institutional investors. Although equity markets have been strong so far this year, the volumes have been relatively weak. Many investors are sceptical of the gains in the equity markets and are sitting with a large allocation to bonds in their portfolios. With most AAA-rated safe-haven sovereign bonds yielding a *negative* real interest rate, the likelihood of capital losses in the bond market as a result of yields rising is, in our opinion, just a matter of time. So with the light positioning in equities, a strong likelihood of medium term losses in the bond market and yield-seeking investors (i.e. pension funds) attracted by juicy dividend yields in stocks, the medium term outlook for equities is in our opinion positive.

Be that as it may, the future is by no means certain, and after the strong rise so far this year in equity markets, we are cautious about the near-term prospects for more significant strength. The markets face a number of near-term obstacles (mentioned above) which it will have to navigate and which will likely set the tone for the next directional movement. As we have said before, however, there will always be companies that navigate these uncertainties better than their peers. Our task is to search for such companies and invest your assets in them.

The Maestro Investment Team
22 October 2012