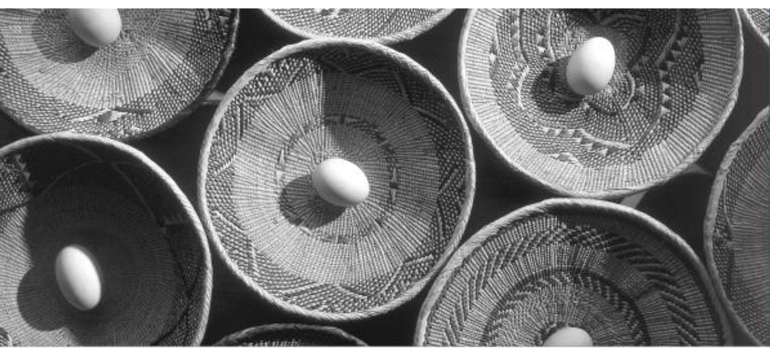

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Monthly Commentary – April 2009

Bonds

Ten year US Treasuries sold off from 2.65% to 3.15% in April, as the market began to digest the avalanche of imminent debt issuance and politicians' best efforts at some sort of reflation. Gilts also suffered a sell-off in the wake of an ominous failed gilt auction in the UK the previous month. In South Africa, the longstanding pattern of monotonic returns across the yield curve was broken and we had a "butterfly" pattern of returns in which short and long dated bonds did better than medium dated maturities. However, all maturities recorded positive returns despite another disappointing inflation announcement. One positive for domestic bonds was a contraction in the South African sovereign risk spread, as appetite for risky assets seemingly resumed. This is even better seen in the strong month for emerging market equities. We retain our view that SA bond yields do not adequately compensate holders for inflation.

Equities

Last month we wrote that we guardedly, nervously and hopefully thought that the local equity market had already troughed in November 2008. In April, the market continued to send out proteans that this may indeed be the case, as the All Share rose 1.6%. Much maligned banks rose 5.1% and life assurers rose 7.1%. Apparently the market has decided that Old Mutual is not, after all, a bankruptcy candidate. Its share price, since recent lows, is up 81% in rand and 113% in sterling. A further contribution to a relatively good month for our clients came from the 21% fall in gold shares, in which we have no holdings.

Since their respective recent low points, there have been some very notable equity market rallies:

World	31%
USA	29%
UK	28%
Germany	34%
France	30%
Japan	18%
Emerging Markets	46%
South Africa	57%

All figures are in USD, and are based on FTSE Indices. These figures may look very different to published numbers over whole numbers of months, because we have used daily data. The various local minima occurred during very volatile months.

It is the case, as we have remarked before, that equities can be expected to recover well before we know that recessions have ended. In previous US recessions, equities have tended to bottom on average six months before GDP bottomed. That and the sheer size of the numbers in the table above suggest that this rally has been unusually large, fast and perhaps partly premature. Some of this may be explained by the earlier severity of market falls, and the subsequent, unparalleled and synchronised political effort to abate a worldwide recession. Patterns and novelties aside, we always defer to what we regard as the paramount technique for attempting to gauge likely future returns: valuation. In this regard, developed markets' equity valuations look reasonable compared to their respective government bond markets. However, within the narrower scope of equities alone, the US in particular appears to have discounted an improbably rapid resumption of a normal earnings cycle. Value managers such as ourselves prefer markets overly braced for negative outcomes, as was the case in nearly all equity markets earlier this year.

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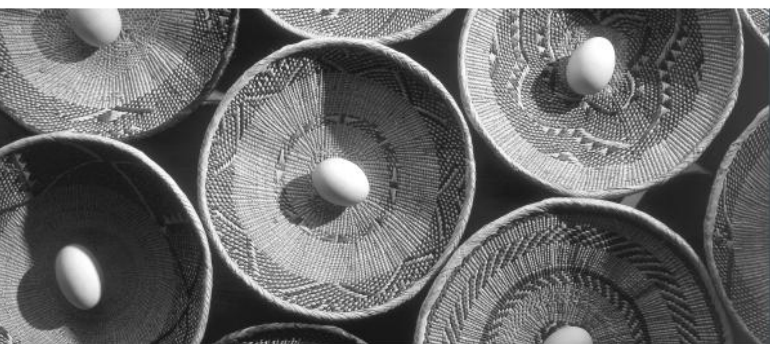

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Several optimistic politicians have recently been risking the use of an old, pilloried cliché in claiming that there are "green shoots" visible in the economy. In fairness, there is some truth to this. Various leading indicators appear to be troughing (i.e. the second, if not the first derivative of these indicators has turned positive). Three month USD LIBOR has fallen sharply. Yield spreads on many corporate bonds, especially banks, have narrowed sharply. Volatility has fallen across many assets. Importantly, in our view, yields on 10-year government bonds exceed those of two-year securities by at least 1 percentage point in all the G-7 nations for the first time since before 1991[†].

The strength of the rand has been quite amazing. The fecundity of such a phenomenon quickly becomes manifest among many commentators. Included in the newfound explanations to have been spawned are the return of waves of retrenched South Africans from Dubai and London, and the uptake of the so-called carry trade in which all manner of investors, including Japanese housewives and German doctors, starved of yields at home, borrow in their own currencies and lend in higher yielding currencies such as the Australian dollar and the rand. That strategy failed abjectly in 2008, but perhaps it is regaining popularity. Either way, we doubt whether the rand's strength can be explained so simply. As we have been at pains and in a tiny minority to point out, neither SA equities' nor SA bonds' prices are correlated to foreign activity (net buying or selling).

Our proprietary indicator of value, the inferred equity risk premium, remains attractive, albeit a bit less so than a few months ago. We place no store by earnings forecasts insofar as these have dire track records but insofar as they impinge on market valuation anyway, we note with some interest that the consensus 12 and 24 month forecasts for the earnings of the JSE All Share Index, compiled bottom-up, have stopped falling. Also, the SA yield curve has flattened appreciably over the past few months. There appears to be a genuine intention on the part of the incoming government to maintain the sound monetary and fiscal policy that has served the country so well for a number of years. Even within a prudent framework, there appears to be ample scope for lower short term interest rates, which, if indeed justified in good time, should be neutral for bonds and positive for equities. More aggressive interest rate cuts would be bad for bonds and very positive for equities. Overall, the bullish case for equities has diminished through sharp appreciation in prices and the gradual disappearance of almost universal pessimism, but valuation does remain fairly attractive. The equities we hold on your behalf demonstrate even more attractive valuation characteristics than the overall market.

Rowan Williams-Short
CIO
Orthogonal Investments

†Source: Bloomberg.

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