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Monthly Commentary – April 2011

The unthinkable – a US downgrade?

US government bonds are not the definition of a AAA rating, but for decades they have been regarded as such by both academics and practitioners. Regular readers will know that we are not great fans of rating agencies, which are hopelessly conflicted and have questionable track records (think of Enron's AAA rating). Still, it came as a huge surprise when Standard & Poor's revised its AAA rating on the US down from "stable" to "negative". In S&P's lexicology this means a 33% chance of an actual downgrade within two years. A longstanding quip in the markets is that if America was classified as an emerging market, the IMF and World Bank would have declared it incompetent to manage its national accounts. To be sure, America's finances are in a woeful state, but we do not believe that a downgrade will materialise because America does not borrow in foreign currencies. Therefore, inflation aside, it could simply print its way out of debt. (It is this thinking that leads to our view that SA's foreign borrowing program is bad, not good, for rand denominated bonds).

The gravity of an actual US downgrade should not be under-emphasised. All income producing assets, including shares and bonds, are priced with some variant of a discounting model. It would be a strange day if the world needed to recalibrate all security pricing to Swiss bonds, or those issued by Australia, Canada, Denmark, Finland, France, Germany, Guernsey, Hong Kong, Lichtenstein, Luxembourg, Norway, Singapore, Sweden or the UK – these are the countries that retain a AAA –"stable" rating from S&P.

Stormy weather for Resources producers?

The mining giants BHP Billiton and Anglo American both published quarterly production reports in April. Expectations were for encumbered figures of especially coal and iron ore in flood-ravaged Australia (what Queensland Treasurer Andrew Fraser called "a disaster of biblical proportions"). Overall, Anglo was harder hit, with copper production in South America and iron ore production in South Africa also suffering from weather and other impediments.

While these disruptions will impact the companies' short term earnings slightly, we think that longer term supply / demand balances in the mentioned commodities still hugely favour the producers. Of itself, this would not attract our attention much, but, unlike gold and platinum miners, these businesses seem to be priced for permanent (and substantial) price falls in iron ore, copper and coal. This is especially pertinent, since, as we write, bearish economic data is causing a mini-stampede as investors flee commodity names for "safe haven" assets. With the whiff of panic in the air, some bargains are bound to present themselves.

Old Mutual - structural reorganisation gathers pace

News emanating from Old Mutual continues to improve. In early August 2010, the company announced that it was selling its US life operations to affiliates of Harbinger Capital Partners for about £220m. This was welcome news at the time as there had been, for some time, concerns about Old Mutual's exposure to US credit markets. The anticipated closure date was December 2010 so when this came and went, we became concerned about potential risks to the successful conclusion of the transaction. We were, therefore, gratified when Old Mutual announced completion of the sale on 7th April. This sale not only improves the group's credit risk profile but also reduces the economic capital at risk.

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