

Monthly Commentary – January 2009

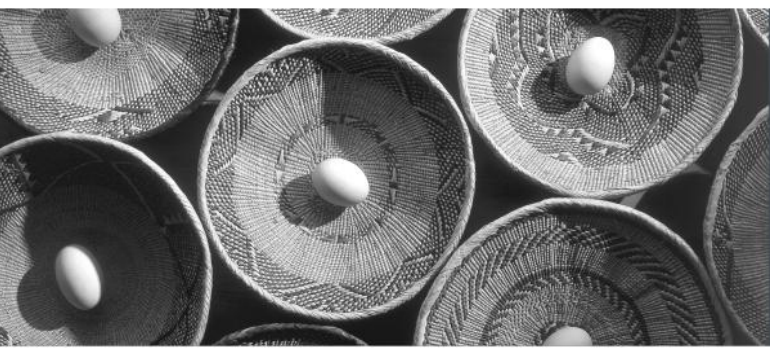
Last month we declared that we have a bond bubble. Ten year US Treasury bonds had traded as low as 2.1% (and 3 month bills traded at a bizarre and memorable minus two basis points). This is apparently on the back of a terrified market being goaded into these assets at any price, rather than holding equities. So we have an era not of risk-free bonds but of return-free bonds. Recently 10 year Treasuries have sold off slightly, to 2.9%. Meanwhile, estimates of the imminent supply of US bonds soar by the day and currently stand at between \$1.5 trillion and \$2.5 trillion (the range alone is scary) even *before* funding the stimulus plan of about \$900 billion. Quite who will buy these bonds is unclear, as the ability of the usual candidates to do so plummets: Japan, Russia, China and various sovereign funds, especially in the Middle East.

To our dismay and disappointment, the sell-off in over-priced South African government bonds has also been muted. On the other hand, we have been pleased by the normalisation of the yield curve: shorter dated bond yields have recently fallen while long dated bond yields have risen. We now have a virtually flat yield curve, but bonds remain beholden to a very favourable path in inflation. It is easy to see how such a benign forecast could go awry; more importantly, if it does, how there could be a sharp rise in yields across the curve. Our clients' funds are well positioned for such an eventuality.

In what has recently become a painfully familiar pattern, the equity market began the new year with some promise, being up as much as 6.60%, before succumbing to another bout of worries regarding the success or lack thereof of the massive bail-out packages being planned around the world, and finishing January down 4.25%. At one point intra-month, it was down nearly 9%.

Despite the preponderance of domestic companies with December financial year-ends, the lag in preparing results means that January is a seasonally low month for company results. Instead, market participants watched in some fascination as the incoming president of the US began determining policy even before his predecessor, who had become a rather unlamented lame duck on the back of dismal public opinion ratings, had left office. It seems the former president had not been "misunderestimated" after all. President Obama was inaugurated in a very expensive (\$120m) ceremony, amidst enormous adulation. At the opposite end of political exhilaration, the entire coalition Icelandic government became the first government to collapse as a result of the global financial crisis. Iceland's brand new Prime Minister Johanna Sigurdardottir promptly fired her country's central bank board, which was widely blamed for the banking collapse that destroyed the economy. We would not be surprised if ultimately the inordinate expectations on Obama's shoulders disappoint and the much lower hopes for Sigurdardottir's success surpass on the upside.

The world is awash with stories of current gloom and more to come. These include: write-downs and credit losses in global banks amount to \$1trn (68% of this in the US and 29% in Europe); Ireland looks to be following Iceland into bankruptcy; corporate bond spreads (excess cost, over government bond yields, that companies must pay to borrow money) are at 100 year highs; unemployment rates are soaring; house prices are collapsing; tax rates are rising; China's exports have fallen by 60% and growth in its power generation has turned negative; Asia's foreign reserves are being decimated, and so on. In all this, spare a thought for Sol Kerzner, who spent \$20m on the opening ceremony for his Atlantis Hotel in Dubai the very day before what is now regarded as the start of the plunge in that Emirate's economy. The sorry state of the world economy does **not**, however, necessarily mean a worry for equity markets. We have demonstrated previously how equity markets can have low correlations to GDP growth, and they certainly lead economies, as they did on the way down in the current cycle. And, there are quite a few promising signs: the spread of LIBOR over Treasuries has contracted sharply (meaning that interbank lending is gradually resuming); investment grade corporate bonds in the US are pricing in 40% defaults in the next 5 years even though the most apocalyptic forecasts fall



well short of that; in many countries equity valuations are nearly at all time lows against government bond valuations (although this could also mean that government bonds are extremely expensive, or most likely, a bit of each); for the S&P500, the average constituent's market capitalisation is 30% below the replacement costs of the firm's assets (i.e. Tobin's Q is 0.7, a level last seen in the mid-eighties and only a few times before that). To elaborate on the importance of corporate bonds, in all previous US bear markets, this asset class has bottomed shortly before equities, and has been a good leading indicator:

Timing of corporate bond and equity market bottoms

<u>Corporate-bonds bottom</u>	<u>Equities bottom</u>
June 1921	August 1921
May 1932	July 1932
January 1948	June 1949
February 1982	August 1982

Source: *Anatomy of The Bear: Lessons From Wall Streets Four Great Bottoms, Russell Napier*
 (Orthogonal Investments acknowledges Bedlam Asset Management in London for drawing our attention to this research).

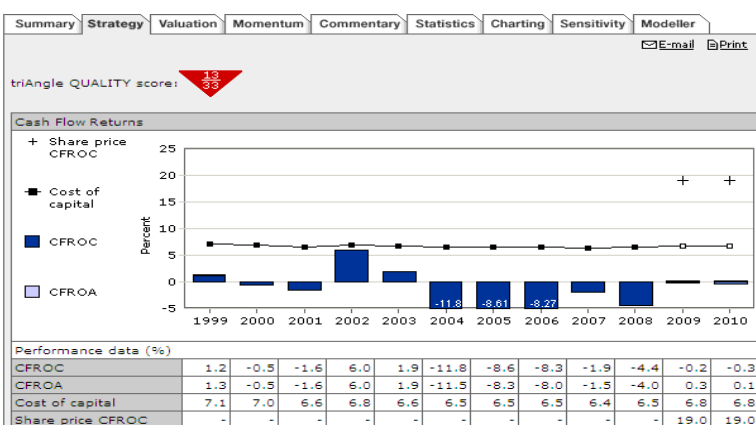
In South Africa, the only sector apart from the tiny pharmaceutical sector to appreciate meaningfully in January was the gold sector. On your behalf we hold no direct gold shares, which we regard as offering poor value:

Anglogold: With 2009 capital commitments in excess of US\$1.2bn, higher finance charges after debt restructuring and the continuing handicap of the remaining hedge book on gearing to a rising gold price, a scant margin of safety seems present at the consensus 1 yr fPE of > 12 and a forward dividend yield < 2%.

Goldfields: Gold production for the Dec '08 quarter was 5% better than the previous quarter and US dollar unit costs are improving. Equity holders will however suffer a (further) ~8% dilution of their capital in March, when 50m new shares are issued to Mvelaphanda. The company is overvalued at a fPE of > 18 and a forward dividend yield < 2%.

Harmony: The most marginal of the big 3 producers is priced for cash flow returns on its equity not achieved in more than a decade, if ever, despite a recent lowering of production guidance for its fiscal Q2. (See graph). Caveat Emptor!

Harmony Gold Mining Ltd



Source: Quest.

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