

Monthly Commentary – May 2009

What a month! The JSE was up 17.4% in dollars, bringing its year-to-date dollar performance to 29%. This lagged the MSCI emerging market index which is up 38% ytd. From its recent low point on 20th November 2008, the JSE is now up 77% in dollars, against emerging markets' 66% over the same period.

We were taught at university that US government bonds essentially defined the risk free rate and hence were the benchmark for a AAA rating, the rating to which all other borrowers, be they governments or companies, should aspire. Now we learn that the US government's rating is under threat! Of course, as we have stated in these monthly reports before, rating agencies have shown themselves to be little more than lagging indicators, and they disgraced themselves regarding sub-prime related issues, but this is still amazing news. As somebody once wonderfully quipped, if America was an emerging market, the IMF would have noted incompetent financial management and declared that they would have to take over the running of the economy! Being the printer of the world's reserve currency spared America that ignominious fate, but that status is increasingly under threat.

Bonds

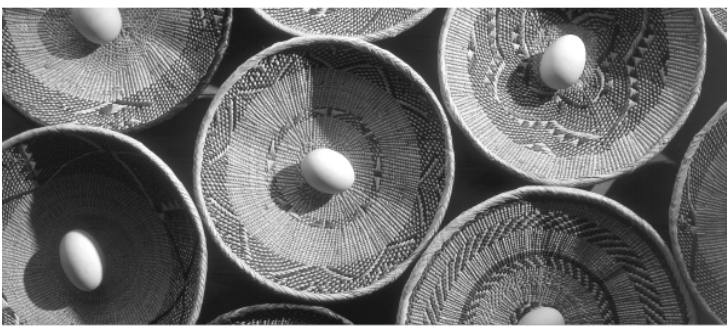
Meanwhile, rating agency Standard and Poors did, on 21st May, revise the UK government's AAA rating outlook from stable to negative, citing "deteriorating public finances". As always the market was one step ahead and previously "go-go gilts" had already sold off by 75 basis points in the previous two months. Likewise, the avalanche of new US bonds about to be spewed onto the market has seen 10 year Treasury bonds sell off by 130 basis points this year. Despite the strength of the rand in May and a shocking first quarter GDP, domestic bonds could not ward off offshore contagion and the ALBI was down 0.43%. The April CPI figure was released and showed that consumer prices increased by 8.4% year-on-year. Against this, 10 year yields of 8.8% hardly look attractive. The dividend yield on financial shares is 6.34% and these shares have the prospect of significant capital appreciation. The relative case for bonds is further worsened by tax implications for most investors.

The market reacted with glee to an announcement during the month that the government had raised a total of \$1,5bn, which was \$500m more than originally planned. The apparent reasoning is that this offshore issue reduces the domestic borrowing requirement. To us, increasing debt in a currency in which one has no revenues is an extremely bad idea since it raises default probabilities.

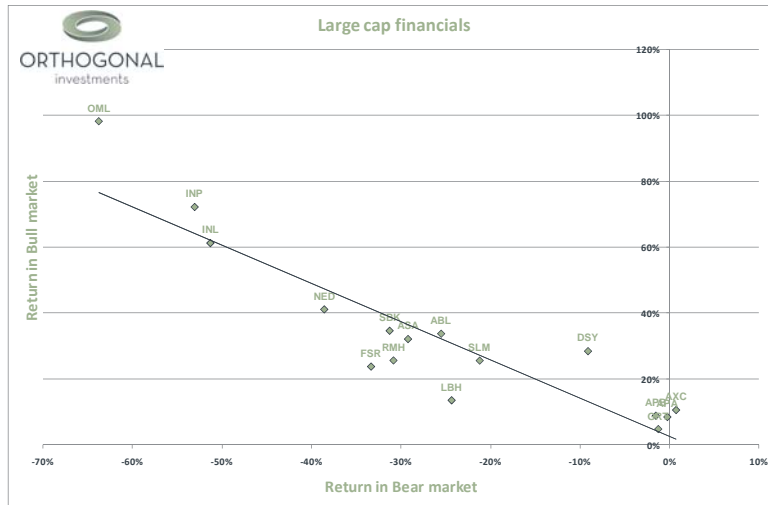
Equities

So, what do we have on our hands: a bear market rally, a dead cat bounce, a fool's paradise, a febrile fantasy or just maybe a fervent start to a new bull market? One thing's for sure: the equity market did not care at all about the appalling 6.4% fall in GDP. We have often remarked that stock markets are *not* particularly correlated to GDP, but this must have been a real blow to top down macro-economic strategists (of whom Orthogonal Investments employs none). First, they never came close to getting the number right; second, it had no bearing on equities anyway. If the GDP figure impinged on the MPC's interest rate decision, that was propitious enough.

A cornerstone of our investment philosophy is mean reversion (first documented by British polymath Sir Francis Galton, after investigating children's adult heights in relation to their parents' heights). It is roughly the observation that awful things get better and excellent things get worse. Recent examples from sport are the IPL cricket championship and the Super 14 rugby competition. We have voraciously read literature on the topic. It is a powerful force in shares' performances, for good reasons. A topical example comes from South Africa's top financial shares by market



capitalisation. The following chart shows, on the X axis, how much these shares fell in the bear market, and, on the Y axis, how much they have risen since then. Total returns have been used for each share.†



† We have defined the constituents and time periods by the J212 index: Peak on 10 Sep 2008, trough on 9 March 2009. Data is up to 31 May 2009. Reinet (new listing) and Liberty International (foreign listing) were excluded.

The statistical fit is very good, with an R^2 of 82%. Those that escaped the rout of last year, notably the property shares, have participated the least in the recovery. Old Mutual and Investec, most tainted by their offshore exposures, have rallied the hardest. Thank you, Mr Galton.

Some company news during May that is of relevance to our clients' portfolios:

Nedbank's trading update showed flat net interest income, rising non-interest revenue (boosted by fair value mark-to-market gains and trading income), a contraction in margin and an increase in bad debts to 1.67% of advances. The share was up 2.6% in May.

Old Mutual's trading update showed an increased surplus and sharply lower impairments in the US. The share was up 13.5% in May and is now up 100% since 9th March 2009 (and up 133% in sterling).

Vodacom's unbundling from **Telkom** was opposed by COSATU at the 11th hour, but the High Court allowed the listing to proceed. Telkom paid a large special dividend but announced that as a standalone entity, it expected its maiden earnings to fall by over 40%.

Liberty Holdings announced a drop in new business. The disastrous consequences of its equity hedging began to become apparent. The share was up 3.4% in May.

Sovereign received a bid from **Afgri**. To us, the terms appear unsatisfactory to Sovereign shareholders. The share was up 26.9% in May.

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