

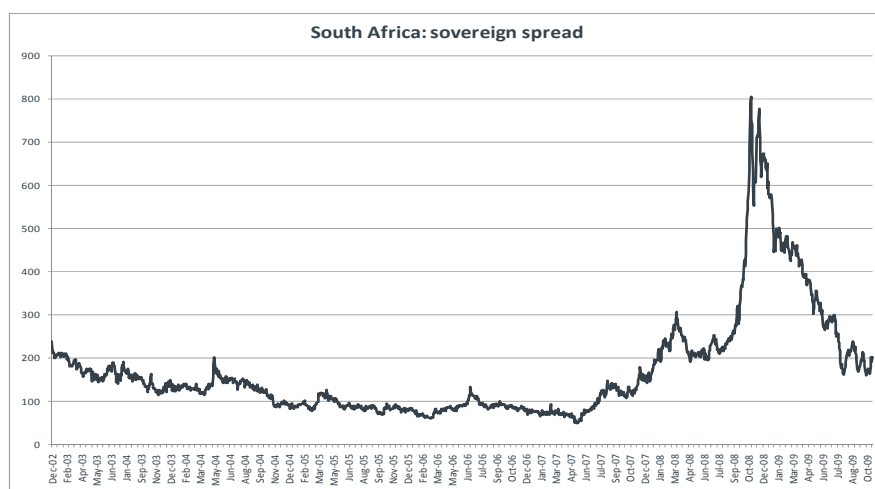


Monthly Commentary – October 2009

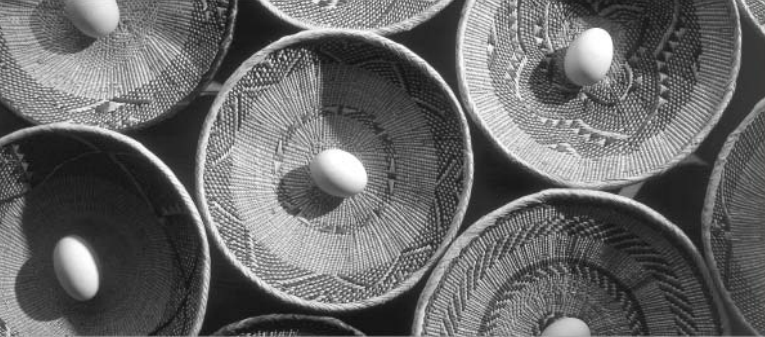
Equities returned 6% in October, helping to dispel the strangely tenacious myth that October is a bad month for stock markets.

It has been incredible just how fast widespread fears and predictions of apocalypse have been replaced by investors wearing emerald tinted spectacles and proclaiming a nursery full of “green shoots”. News that is awful, just less awful than had earlier been expected, is now being regarded as unambiguously good for risky assets. Sure, the mantra of “flight to safe haven” was exposed as nonsense, and risky assets were priced far too cheaply just six months ago, but is such a sharp turnaround justified? To put some flesh on these bones:

- The “safe haven” 10 year US government bond’s yield has weakened from 2.07% in December to 3.41% currently. As a percentage increase, that’s the worst 10 month period there has been in data we have from August 1976.
- In rand terms, South African equities are up 52% since the recent low on 20th November 2008.
- In US dollar terms, South African equities are up 110% since the recent low on 24th October 2008.
- South Africa’s risk rating as measured by the spread of its 10 year government bond yield over the 10 year US government bond yield (the sovereign spread) has plummeted from over 8% to under 2% in just a few months. Nobody can possibly believe that the country’s genuine financial standing could have changed by remotely that much, on the way down or up, in such a short space of time. In fact, it is incontrovertible that the country’s fiscal position has *worsened* in the past six months. To add to that, South Africa finds that its ranking within those emerging countries sophisticated enough to have liquid markets in dollar denominated debt has bolted from middle of the pack to best. Of course, none of these two interpretations can be correct, leaving one plausible explanation: markets have been mad.

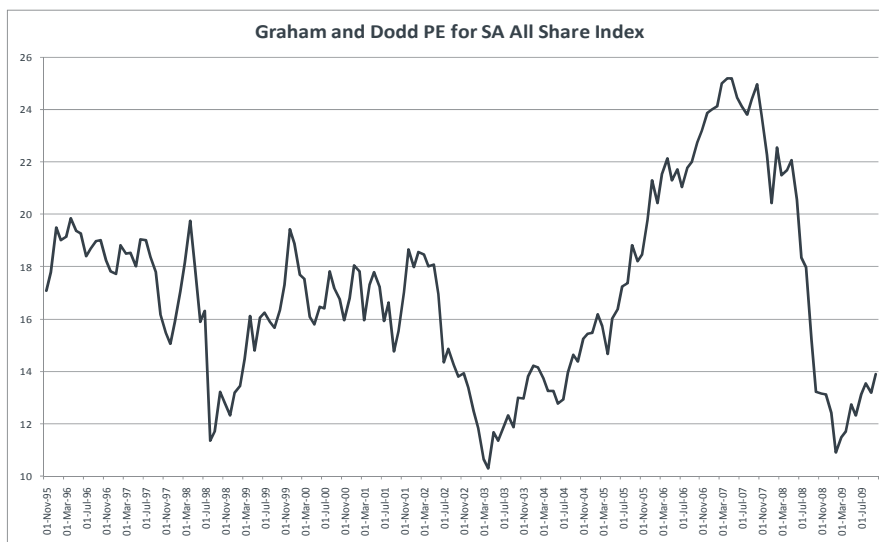


Source: JP Morgan, MorganMarkets.



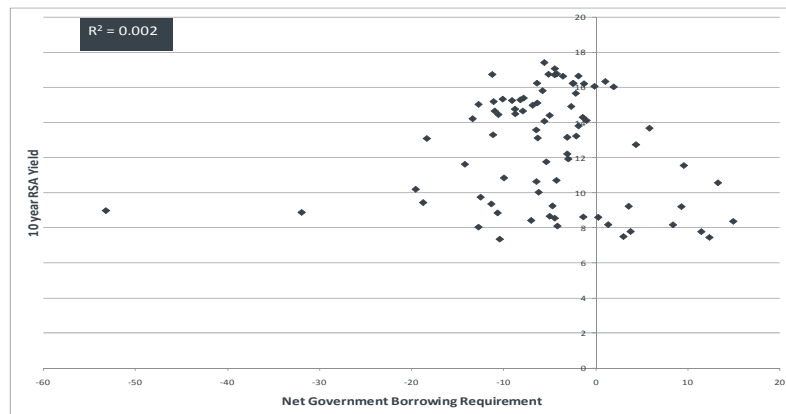
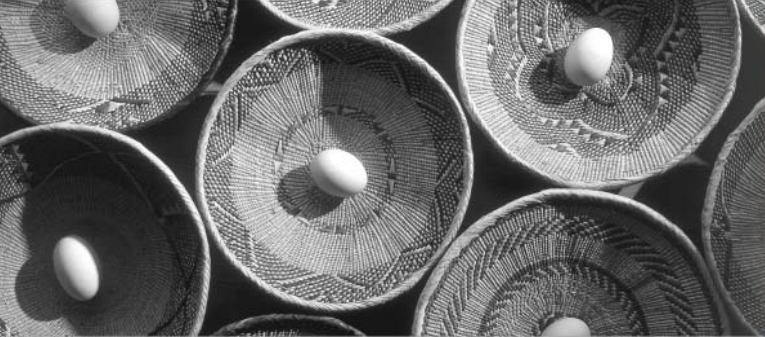
Leaving aside fallible forward PE ratios, it is sobering to note that the current historical PE ratio on the All Share Index is 15.44. In the era of the new South Africa (financially), namely since 1990, that represents a reading only half a standard deviation above average, but it's still a reading on the wrong side of good value. The market has moved from a stance of seeing no hope for a recovery in earnings in a very long time (the PE was just 8.2 as recently as March; the lowest in the new era) to being very confident or hopeful of a substantial earnings recovery soon. That worries value investors like us. Meanwhile, the actual weighted earnings growth in the companies that comprise the All Share Index has been *minus* 19% over the past 12 months. Six months ago, bottom-up, aggregated consensus earnings expectations for the ensuing 12 months were -6% and today these are +23%. Heroic assumptions about these forecasts having a rather rare moment of accuracy are needed.

We prefer to take solace from the Graham and Dodd PE, which de-emphasises noisy current data in favour of longer term observations. It concurs with our proprietary implied equity risk premium (not shown) in regarding the market as still being fairly attractive; just much less so than six months ago.



Source: Orthogonal Investments.

During October, the new Minister of Finance presented his maiden Medium Term Budget Policy Statement and handled the occasion well. Attention was focused on the 7.6% forecasted budget deficit, which rises to 11.8% when all public debt (including Eskom, Transnet etc) is considered. Bond analysts filled reams with their thoughts on this, and what it might mean for bond supply and ultimately bond yields. The truth is that this topic is just an investment myth. In fact, there is no relationship between deficits and bond yields. The chart below demonstrates this.



Source: Cyrus, Orthogonal Investments

Rather, we think the bond market should concern itself with inflation. Eskom's electricity price increases are, in our opinion, being brushed aside too lightly. We believe that inflation needs to average less than 5% over the next ten years to justify current bond yields, and we are prepared to bet against that.

Some company news during October:

Xstrata (not held) dropped plans for a merger with **Anglo American** (held). As George Orwell said in *Animal Farm*, "All animals are equal but some animals are more equal than others". Apparently the respective CEO's, Mick Davis and Cynthia Carroll both regard their companies as more equal, thus making a merger of equals impossible. The absence of any control premium did not help.

Old Mutual (held) decided to have a game of merry-go-round and announced another bid to take out the minorities in Mutual and Federal, and met with some resistance as before. We gather though that this time there is enough support for the deal to be concluded. Recently they tried to sell their entire holding in M&F. Meanwhile, we estimate that the group's embedded value will have increased substantially since the date of the last disclosed EV, June 2009.

Standard Bank (held), like the other banks, indicated that margin pressure and impairments were leading to lower earnings. Like lemmings, analysts downgraded earnings expectations after the announcement.

Rowan Williams-Short

CIO - Orthogonal Investments