Quote of the month

All through time, people have basically acted and reacted the same way in the market as a result of greed, fear, ignorance and hope. - Jesse Livermore

The End of Low-Yielding Treasuries?

For months it seemed that nothing could stop Eurozone government bond yields from falling, but in a little over two weeks, German 10-year yields have risen to 0.55% from a record low of 0.05%. The speed at which these yields have risen is remarkable and has reversed the decline of the previous three and a half months.

Part of this reversal may be explained by a declining fear of deflation in Europe due to rising oil prices. Another explanation is that the treasury market overheated due to the European Central Bank’s government-bond purchase program. Speculators bought Eurozone bonds at yields they regarded as unreasonably low, purely on the expectation that they will sell them to the ECB at an even lower rate.

The speed of the sell-off may have been a bit alarming, but the reversal is a welcome return to normal conditions. Bond yields were also supported by Bond Kings Bill Gross and Jeffrey Gundlach, who recently called betting against Bunds the short of the lifetime, due to the unsustainability of negative interest rates.

U TURN – Yield on 10-Year German government bond, %

Yields are not only rising in Europe: Australia, for example, even saw yields jump when the Australian Central Bank cut rates this week, the reverse of what normally happens. Bond market measures of expected inflation have risen sharply since bottoming earlier in 2015 in the Eurozone, US, Japan and the UK.
In America, big corporates are racing to issue bonds as time is running out to lock in borrowing costs while they are still near record lows. The yield on the 30-year Treasury Note, a benchmark for everything from corporate debt to mortgages, has risen by 52 basis points since the start of April to 2.99%, touching the highest level in five months. The average yields on investment-grade debt have also risen, climbing to 3.08%.

In conclusion, it seems that treasury markets have moved back to a normal, positive rating environment and if some analysts are to be believed, we may be at the start of a bond bear market.

Have we reached the stage where global infrastructure investment starts to accelerate?

Last month we looked at developments on the ground and particular in China with the “New Silk Road” project. In an article called “Emerging Markets: The Great Unravelling?”, Jawad S. Mian states the following: “If I am correct in my view that China is in the early stages of a new long-term bull market, then emerging markets as a whole will not be left behind for too long. The economic integration modelled by China, with Xi’s vision of a ‘New Silk Road’, holds the promise to provide a structural tailwind.”

Tailwinds that can only grow stronger, with Asia’s third largest economy, India, drawing our attention - as new Prime Minister, Narendra Modi, embarks on his new government flightpath with a focus on reforms and infrastructure spending. According to India’s Finance Minister, Arun Jaitley, they will spend an additional $11.35bn compared to the previous year and infrastructure spending will rise 43% over the next five years.

In an article released by Reuters, “Urbanising India best bet for Chinese steel” (5 May 2015), India plans a scale of mass urbanisation based on the forecast that India’s population will more than double by 2050. They will construct 100 “smart” cities by 2022, with an estimated cost of $1 trillion.
According to the World Steel Association, India will be the biggest consumer of steel in both 2015 and 2016, with demand increasing to 6.2% and 7.3% respectively. India’s imports increased 71% by fiscal year-end March, with most of the imports coming from China.

Modi also implements a more open policy in attitude and culture to attract industries and foreign investors, whereas in the past it was described as a level of “sadism”.

According to the International Monetary Fund’s World Economic Outlook released in April, India’s economic growth will climb to 7.5% versus China’s 6.8%.

**India Pulls Ahead**

Chinese growth will lag India’s starting in 2015, International Monetary Fund projections show

How do we capitalise on this growth story over the next 5 to 10 years? A clear beneficiary would be BHP Billiton.

**BHP Billiton creating value through South32 demerger**

BHP Billiton announced plans for a demerger in August 2014 and in March 2015 the company’s Board of Directors recommended that shareholders vote in favour of a demerger of its assets into a new company to be called South32.

Shareholders approved of these plans on the 6th of May. South32 will be listed on the 18th of May in the UK, Australia and South Africa. Analysts are valuing South32 at $12bn - $13.3bn, which compares with BHP Billiton’s market capitalisation of $132.7bn.
The demerger of South32 will simplify BHP Billiton’s portfolio as its current 41 assets would be reduced to a core portfolio of 19. The demerger will enable the company to focus on its petroleum, copper, iron ore, coal and potash assets, which together generated 96% of the Group’s Underlying Earnings Before Interest and Tax in 2014. The company will remain listed on the JSE but will have no operational interests in South Africa.

South32 will become the world’s largest producer of manganese ore, one of the world’s largest ferronickel suppliers and a top source of silver and manganese alloy. It will also have a significant presence in alumina, aluminium and coal, operating in Southern Africa, Australia and Columbia. The company will also start with a strong balance sheet, will have access to a $1.5bn credit facility and in December 2014, 90% of its earnings came from assets operating in the bottom half of the industry cost curve.
According to BHP Billiton’s Chairman, Jac Nasser, the spin-off will create more value for shareholders than other options, including asset sales. The only criticism which emerged on the demerger plan was its cost of $738 million.

What impact will the demerger have on current shareholders?

- Shareholders will retain their existing shareholding in a simplified BHP Billiton and eligible shareholders will also receive a share in South32 for every BHP Billiton share they hold.

- Shareholders will continue to receive dividends from BHP Billiton and they will benefit from any dividends from South32. BHP Billiton does not plan to rebase its dividend following the demerger, implying a higher pay-out ratio.

Conclusion

BHP Billiton remains a quality long-term investment with the ability to outperform peers because of its diverse and quality assets, cost profile and strong balance sheet. The demerger will enable the company to focus on its core assets, unlocking further value for shareholders.
South32, on the other hand, is inheriting some high-quality assets that have been well maintained and there is already speculation doing the rounds that seasoned acquirers such as Mick Davis of X2 and Ivan Glasenberg of Glencore may be interested in the company’s assets.

Watch this space!

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