Investment View August 2011

The term 'rollercoaster ride' has rarely been a more apt description of recent stock market behaviour, with both the biggest one day fall and the biggest single day rise since the collapse of Lehman Brothers in 2008. Volatility creates fear, and even panic, whipping up ever more volatility in an almost self-perpetuating froth of irrationality. But what does it all really mean in practice?

For certain, issues in Europe and the USA have caused great concern to financial markets particularly equities. Economic growth is poor to stagnant in many developed markets, as shown by France's zero growth in output for the second quarter.

But unlike the last time, other asset classes have been unaffected. Index linked gilts and corporate bonds weathered the storm well and property funds also managed to avoid damage, valuations being at a far more robust level than back in 2008. Overseas sovereign bonds have also performed positively.

Our 'multi-asset class' approach to portfolios has again served our clients well, although overall values have inevitably fallen – nobody has devised an 'upwards only' investment strategy and we do not believe such a thing exists. The 'trick' is not to panic and sell at the wrong time, and many commentators now see opportunity in the current valuations in equity markets. As ever, the question is what actually represents 'fair value'. We are confident that markets fell well below that in recent weeks. In our July issue we closed by saying we anticipated a reversal of our recent policy of trimming equity gains, and that is what is happening – moving from capturing profit on the upside to buying back into the dips on the downside. But why are values now considered more attractive?

The USA has had a shot across its bows and its politicians need to be more proactive in sorting out the debt issues, steering the economy away from talk of recession. Europe is not clear of its debt issues but the European Central Bank stepped in and ignored the politicians. France is not being downgraded and that alarm bell has been silenced, although its zero growth in Q2 reflects the anaemic outlook for most developed markets.

Over recent days markets have responded positively and are clawing their way back, but the speed of the climb back is hard to predict. It could be faster than the last time around and it is hard to find a fund manager who is not buying or who doesn't believe that the markets have been greatly oversold. In many ways, markets are in unchartered territory facing so many unknowns, which make it difficult to confidently forecast what will happen next. However, it is the long term that we focus on, not next week or even next month. The key question is what will happen with the global and US economies.

At present, few believe that the US economy is really facing significant fundamental weakness that would lead to a new recession. The economy is being held back by ongoing credit issues and renewed deflation fears. But in many ways, the economy is stronger than it was a year ago.

Unlike the market downturn that occurred around this time last year (the tail end of which can be seen in the graph above) there are some important differences in the economic picture that investors should be aware of. Unlike last year, the growth in the supply of money is positive. Jobs growth is still weak, but is significantly better than it was 12 months ago in the US. Additionally, bank lending is slowly expanding, a particularly important point for small businesses which conduct a great deal of the hiring in the United States and UK. Also in the US petrol prices have been falling, which should help provide a boost to consumer confidence and consumer spending. Finally, the supply chain disruptions that occurred due to the earthquake in Japan earlier this year have mostly eased, which should provide a boost to such sectors of the US economy as auto manufacturing.

For all of these reasons most commentators believe it is unlikely that the United States will be entering a recession any time soon. US growth in the second half of 2011 will not be strong, but may not be as weak as the markets have feared. The same is true for the UK. The risks to the economy and the market are well known, but it is equally important to recognise that there is also a list of things that could prove positive.

The trend of economic data may move from negative to mixed. This is likely to continue to result in above average volatility, as each new news item surfaces. It is very possible that some positive surprises may arise in the economic data, reflecting strong earnings that many companies are achieving. The July US employment report was stronger than expected, so maybe that represents the start of this trend. German business confidence remains at a near-record high and the Bundesbank, which predicts the economy will expand 3.1 percent in 2011, says the outlook remains “favourable”. Factory orders in Germany, Europe’s largest economy, unexpectedly rose for a third month in June, boosted by investment goods such as machinery. It’s a good start.

It is hoped to see some clarity around the European sovereign debt issues. Europe will likely remain a troubled region and growth will be weak, but it is viewed as likely that the Eurozone will hold together. Chinese policymakers may be successful in lowering inflation which would also take some risks out of the market. The Federal Reserve action could also represent a potential positive. A new "QE3" has been to provide clarity on interest rates and that has been well received.

In the US, there appears little likelihood that Congress and the President would be able to agree on a wholesale reform package that would result in significant structural changes. However, the risk of being accused of fuelling weakness in the economy could prompt the parties to come together to enact some new policy initiatives. More likely would be some sort of agreement to extend the current payroll tax cuts or unemployment benefits, both of which would help promote economic growth.

Corporate earnings have long been a source of strength, and despite the weakness in the economy, companies have been able to show impressive growth. The most recent data from the second quarter shows that over 75% of companies have beaten expectations. The average out performance has been by 5%. This is not a new phenomenon. Earnings are up 128% since the market lows in March 2009. In contrast, the S&P 500 is up 80% over that same time. As a result, stock valuations are more attractive now than they were when markets were at their worst during the credit crisis.

There has been a great deal of fear and risk in the markets, and no one would surely suggest that everything will be smooth sailing from here, but nothing that has happened over the last couple of weeks fundamentally alters the outlook for stocks.

If investors can believe that the US will avoid recession, then further investment in risk assets makes sense. Cash is still yielding essentially zero percent, and Treasury yields have fallen sharply as well, so compared to alternatives, stocks continue to represent an attractive long term option. We expect to see continued high levels of volatility in the weeks ahead given the lack of clarity around all of the issues outlined earlier, but we do believe that conditions should improve

Two weeks ago, no one suggested that stocks were expensive. Now, with markets lower by many percentage points, stocks were pricing in a more negative scenario than many expect. This suggests that the present market represents an opportunity to buy. For those that like history and facts, since 1962, there have been 25 corrections greater than 10% during bull markets. Nine of these instances became bear markets. Historically there is a 64% probability that this is only a correction and not the start of a bear market. The average correction is 13.2% and lasts 118 days.

Wall Street has never been surer that the Standard & Poor's 500 index will rally in 2011. Chief strategists at 13 banks from Barclays Plc to UBS AG see the benchmark measure of American equities surging 17% through to December 31, the average estimate in a Bloomberg survey.

Our consistent and systematic approach will continue to pay off but as ever ‘patience’ is the watchword. Having successfully weathered the last two market crashes we will stick to our strategy!

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