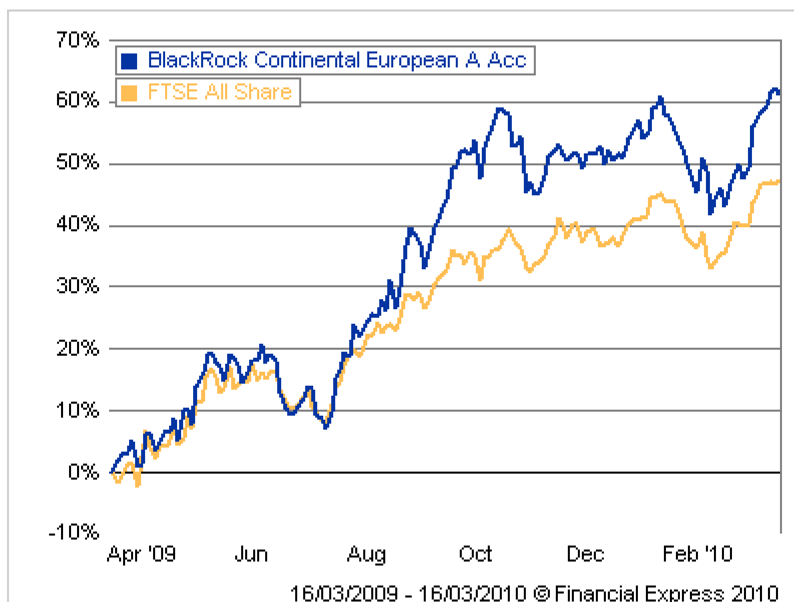
Investment View – March 2010

We have now passed the first anniversary of the low point of the bear market, with the MSCI World index rising 61.7% since then. The global recovery continues to unfold. In the Eurozone, industrial production rose 1.7% in February - the largest ever monthly gain, while in the US retail sales surprised on the upside, rising 0.9% in February following a solid January increase. Following a period of increased volatility across the globe the 'VIX' volatility index recently fell to a 22-month low of 17.3.

However, the latest economic growth data from the National Institute of Economic and Social Research (NIESR) shows that the UK economy is growing only weakly, expanding by 0.3% in the December to February period. Their analysis comes a month after official figures were revised up to show the economy expanded 0.3% in the final quarter of 2009 from the 0.1% previously reported by the Office for National Statistics (ONS). This is a disappointing and purely technical end to a recession and the UK is looking at a very sluggish year for growth in 2010 and could actually be as little as 0.5%. We do not expect UK economic output to return to the peak seen at the start of 2008 until 2012.

The UK's trade gap with the rest of the world also widened unexpectedly in January to its largest since August 2008 and exports saw their sharpest drop in more than three years. The fall in the value of the pound, making UK goods cheaper abroad, might have been expected to boost sales overseas. But in the current difficult economic conditions, UK manufacturers may have taken advantage of a weaker sterling to increase their profit margins rather than increase sales. The pound has fallen by some 24% against a basket of world currencies since early 2007. The weakening of sterling is taking time to feed through.

Inflation has also jumped but once you factor out the VAT ‘distortion’ inflation will fall back over the rest of the year. The UK government's quantitative easing programme has been put on hold. However, with the Bank of England view on the economy remaining cautious in their recent ‘inflation report’, a return to gilt purchases cannot be ruled out. The extent to which a further increase in the QE policy would help the economy is now questionable.



In Europe growth of 1% is predicted this year following disappointing Q4 2009 growth. But data has been surprisingly positive, with France, Italy and Germany all outperforming consensus expectations. Indeed, industrial production is now expanding once more from year-ago levels, confirming a shallow recovery.

The consensus has been negative on Europe focusing on the problems in Greece. However we believe we have been vindicated in our judgement to switch some of the UK exposure to Europe e.g. through Blackrock Continental European as the performance above shows.

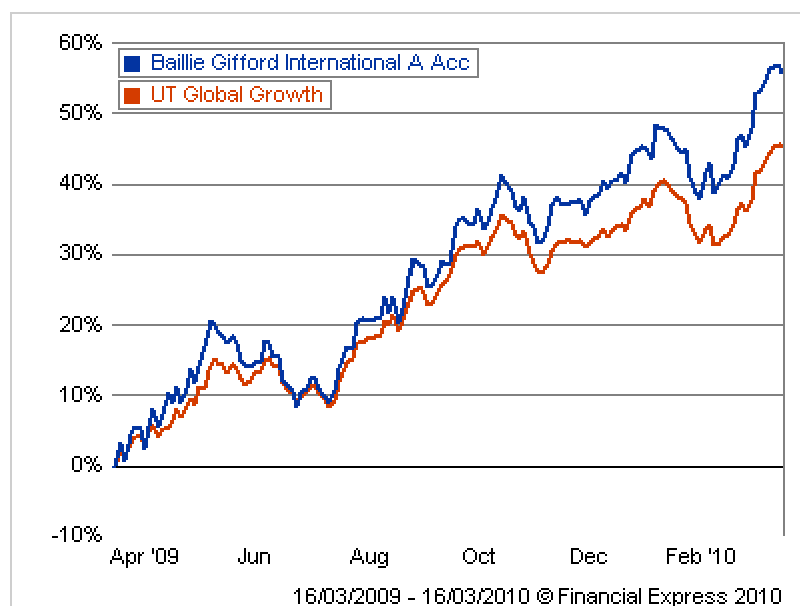
It is difficult to see strong domestic demand emerging from within Europe during 2010 as unemployment increases and even the core countries are fighting against larger deficits. However, the increasing evidence of recovery in industrial output in the region makes a strong case for maintaining current exposure levels in portfolios instead of higher UK content particularly with increasing fears of a lack of decisive action on the UK economy if there is a hung parliament.

Short-term economic momentum in the US appears strong and the 2009 Q4 GDP growth has recently been revised up to an annualised rate of 5.9%. This is expected to be sustained in Q1 2010 due to the Obama stimulus package but forecast US economic growth for the whole year is just 2.5% as a result of weak consumption due to depressed home prices, a difficult labour market and high debt levels. Some removal of emergency liquidity measures, introduced at the height of the crisis, is expected.

On a more positive note there has been recent good news on corporate profitability. Fourth quarter trading reports from around the globe have been ahead of expectations, partly due to continued cost cutting but also from better than expected turnover levels. This in turn has led to cash generation which is likely to support merger activity. Improved earnings combined with attractive valuation levels and an expectation of low official interest rates for some time gives grounds for optimism on the outlook for equity markets over the year despite the political and economic headwinds.

The outlook for smaller companies is still fragile according to surveys and in portfolios holding a Smaller Cos fund we will follow the shift towards Europe in the large cap sector with a similar shift for small cap funds. For Europe as a whole we do not see any need to change our views at this stage even although peripheral problems exist. Fresh industrial data provided evidence that the recovery had not been as flimsy as many had been led to believe by headlines about sovereign debt.

Greece is nevertheless now under massive pressure to cut public spending in the way that Ireland has had to do and this will bring additional headline grabbing social unrest. Whilst confidence in sovereign debt remains volatile the euro will remain vulnerable against the US dollar.



We are still positive on the outlook for emerging markets and most portfolios will continue to have some exposure, if not directly, then through funds such as Baillie Gifford International which is 25% invested in emerging markets.

As ever it is a question of balancing the risk and emerging markets are not for the faint of heart or those approaching their later retirement years!

Emerging market bonds have also had their best start to a year on record as issuance has surged and yield spreads narrowed to their tightest levels over US Treasuries, the global benchmark, since June 2008. Riskier assets, such as emerging market debt, were helped by more stability in the European government fixed income markets after Greece successfully issued bonds.

Emerging market sovereign bonds deals have reached a record $127bn so far this year, a 36 per cent increase on last year – the previous record. Credit valuations were back at historically relatively normal levels after years that swung between the wildest optimism in 2007 and, in 2009, the deepest gloom, which priced in outcomes worse than the Great Depression!

Current spreads in corporate bonds are now much closer to their long-term averages and generally are considered to provide adequate protection against ‘default’ risk, and analysts expect default rates to fall sharply. Last year default rates peaked above 10 per cent but are expected them to drop to about 5 per cent in Europe and 6 per cent in the US this year. Government bonds are likely to weaken in the near term as quantitative easing comes to an end. Improving economic growth, rising inflation, normalising interest rates, and heavy issuance will send government bond yields higher in 2010.

Steve Patterson - Investment Director