CFG Wealth Management

SIFA MEMBER

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There has been no single catalyst for the recent stock market decline. Instead a toxic mixture of political, economic and financial gloom has continued to trouble the markets. And after years of living beyond its means, the harsh reality is now dawning that the US economy may be in for a period of significantly slower growth. The US is not the only economy facing this reality but it is the most high profile and that has undoubtedly added to the markets uncertainty.

The protracted US 'debt ceiling' debate and the subsequent shock downgrade of the US by Standard & Poor's from 'AAA' to 'AA+' did not help. Equally the slow response of the Eurozone politicians to the problems of peripheral economies and the 'knock on' to those such as Spain and Italy has been just as damaging leading to fears of a synchronized global slowdown with the potential negative impact on corporate growth and earnings.

The big questions now are (a) can we trust the politicians to deliver the outcome required by markets, and (b) following the falls in August and September, what are equities already pricing in?

As we all know trusting politicians is difficult at the best of times! But if economists at UBS are right then the cost to Germany of bailing out Greece, Ireland, and Portugal and remaining in the Euro would only be €1000 per head compared to a whopping €6000-8000 if they quit the Euro. As to what is priced into equities, valuations certainly are at levels rarely seen in the last 30 years. The trailing Price/Earnings ratio (PE) is 10x, a level only seen in the 1980-82 recession, and in the worst of the post Lehman credit crunch.

However, despite valuations looking cheap, market reaction suggests investors have little belief in the earnings numbers against the backdrop of economic uncertainty. Against that backdrop 'fair value' lies somewhere in the middle. As the first half of the year showed, economic growth does not have to be robust for earnings to be strong, and some commentators expect earnings growth to remain reasonably healthy. A great deal of uncertainty remains, but we think it is reasonable to expect that earnings growth can continue to be in the mid to high single digits in the months ahead, which implies equities are at attractive price levels on a medium to long term view.

It is clear that sentiment is very negative at the moment but we see this as a relatively short term view. While not wishing to dismiss the significant challenges facing the global economy, corporate sector balance sheets are in excellent shape compared with 2008 when the global economy suffered a sharp and severe slowdown. This provides a 'margin of safety' in the event of a further slowdown, with the potential to increase equity weightings should the environment prove to be more benign than current sentiment envisages. In other words at current valuations the market offers significant upside even in a slow growth environment, although volatility will continue.

If there is a consistent lesson to be learned from similar previous declines, it is that there is enormous merit in having a diversified portfolio. The FTSE 100 is showing losses of around 20 per cent on a peak-to-trough basis, and that hurts. Yet index linked gilts have yet again proved their worth as a defensive holding.

Rank	Sector	1y (%)
1	UK Index - Linked Gilts	12.8
2	Commodity & Energy	12.3
3	UK Smaller Companies	12
4	Sterling Long Bonds	8.6
5	UK Gilt	7.8

Gilts have moved higher on a "flight to quality" rotation, a feature that is factored into many of our post retirement portfolios. Equally corporate bond prices are also now higher than levels seen in the spring and indeed several fund managers have told us that they are moving more heavily into high yield bonds, an area we have favoured for some time for pre-retirement portfolios.

Even for dyed-in -the- wool equity enthusiasts, the evidence for a diversified asset allocation strategy is undeniable! The resulting mixed basket of securities will be less volatile overall, effectively self-hedging itself against many market events. Creating a long term strategy that can mitigate against the storms of the market is a key focus for us in constructing retirement and investment portfolios.
Perhaps one of the surprises is how well the UK smaller companies sector has held up – normally an asset class that is vulnerable in times of economic troubles. As far more people are employed in smaller businesses this is a welcome if unexpected facet of the current investment landscape.

We also continue to favour property, which has fared much better though this summer storm than in the last downturn. As we have regularly stated over the last 6 months - while further capital appreciation would remain

muted for as long as credit remains tight - at current rental yields of around 6.5% property offers excellent value for money on a 'risk adjusted' basis. In the 'high end' institutional property sector strong and quality covenants reflect healthy corporate balance sheets, with very low default risk. While occupier demand may be softening as a result of economic slowdown it is expected that yields will remain attractive.

So where do we go from here?

Europe is clearly attracting very negative sentiment, mainly due to the politicians' failure to solve the market's concern over sovereign debt, with a default by Greece constantly on the horizon. The latest Bank of America Merrill Lynch survey of 286 fund managers found that 55 per cent were predicting two quarters of negative economic growth, compared with just 14 per cent of those surveyed in July. Gary Baker, head of European Equities strategy at BofAML Global Research, said: *"The survey shows that sentiment on Europe is now so negative that contagion risk to the rest of the world has risen significantly."* On the day of writing Moody's downgraded French banks, Societe Generale and Credit, as a result of their exposure to Greek debt.

However, this does not necessarily mean European share values will fall from current levels. As the manager of the BlackRock Continental European Fund commented *"... much of the potential downside associated with a peripheral default is reflected in valuations. Indeed, we think European equities are attractively valued overall but we believe that decisive political leadership is crucial to unlocking this value."* We support this view and in spite of the negative sentiment Europe will remain a key element in most client portfolios.

After years of living beyond its means, the US economy is undoubtedly in for a period of significantly slower growth, whatever the outcome of next year's presidential election. Given the US Government's estimates about what needs to happen to spending and taxes just to stabilise the debt/GDP ratio, both private and public spending trends will be much less robust going forward. The wrangling over raising the national debt limit has not shown either of the main political parties in a good light and some consensus on future strategy is essential.

The mildly encouraging counter sentiment is that 'pace of growth' is now the main issue being discussed rather than 'double dip' recession, rising interest rates and inflation. But if the US politicians fail to grasp the nettle, that will certainly hinder economic expansion, and in turn have an inevitable impact on the global economy. However, this is unlikely to be as severe as it might have been, bearing in mind that much of the global growth is now being generated elsewhere.

In that regard although global growth expectations have moderated, consensus expectations of GDP growth in Emerging Markets over 2011 remain unchanged at 6.3%, emphasising the two-speed world of emerging and developed economies. It is expected this growth differential between the emerging and developed economies will continue, although perhaps not to the same extent as in 2010. Emerging Markets have experienced a V-shaped recovery since the global credit crisis, reflecting their strong underlying fundamentals and continue to be attractive for the long term investor.

It remains impossible to find a fund manager who does not believe that there are buying opportunities with all believing the markets have generally been oversold. What remains uncertain is the strength of the economic tide that may hinder growth, albeit growth remains the focus, rather than recession.

It is plainly the politicians and the policy makers, not the business community, that have disappointed the markets - by failing to agree on some difficult and unpalatable decisions that are required to provide confidence and clear direction to markets. Until that direction is delivered markets will continue to react quite dramatically on every bit of news, each twist and turn, good and bad. Clearer political direction would ease investor anxiety and thereafter allow a positive momentum to build.

Unfortunately that may still be some weeks or months away - but nobody really knows!

Anthony Stephen Patterson, Managing Director.