

Investment View – April 2010

The FTSE All-World equity index rose 1.1 per cent, to a fresh 18-month peak earlier in the month. However, there are concerns that distortions in the global economy and the heavy indebtedness of many developed nations could still upset the worldwide recovery. Prior to the global financial crisis concerns about imbalances in the world economy were on the increase. This was typified by America's large current account deficit and China's massive surplus.

Since the outbreak of the crisis the imbalances had narrowed. But the factors that led to a narrowing (such as lower oil and commodity prices) have now gone into reverse. Furthermore the structural factors that contributed to the imbalances remain. At last September's Pittsburgh summit G20 leaders pledged to promote more balanced current accounts. But many of these commitments have never been fully implemented. Differences in growth rates have also widened with emerging economies becoming an increasing source of global growth but at the same time keen to build up reserves as protection against future crises.

Following a strong first six months we now expect growth in the developed economies will slow in the second half of 2010 and enter 2011 with limited momentum. China will more than likely lead the way in economic activity terms. In its latest estimate, the World Bank had predicted a growth rate of 9.5% for China in 2010, but many analysts predict faster expansion. Growth in the first quarter alone is estimated at between 11 and 12 per cent. But the Chinese government is under pressure particularly from the US to allow the renminbi to appreciate – a move which would make American exports to China relatively cheaper. However, in March China had its first monthly trade deficit in six years and the government in Beijing will remain cautious.

Although I am still quite positive on the economic fundamentals in emerging market equities, in many of these economies interest rates are now on an upward trend and this may make it harder for them to outperform in the short term. By contrast we would expect any interest rate rises in the developed world to be gradual. In this environment, risk assets such as equities should continue to perform positively albeit at a slower pace.

We also expect the combination of high free cash flows, low returns on cash and attractive valuations to drive further M&A activity in the coming months. Currency effects have made UK companies particularly attractive to overseas suitors and may be a focus of corporate activity. Markets are also being driven by upward earnings revisions.

In the fixed income markets, our view continues to be that sovereign risk is rising while the economic recovery is seeing corporate risk still falling. This, together with yield spreads that remain healthy despite the huge demand pushing prices skywards justifies our continued preference for corporate bonds over government bonds.

The UK market advanced in March benefiting from a rebound in market sentiment as investors reacted with relief after the European Union negotiated and ultimately agreed a contingency loan package for Greece. Although the pound is not directly affected the development resonated with UK investors, as Britain also struggles with a very large budget deficit.

Investors welcomed assurances from the Chancellor that the UK government would reduce borrowing. In addition, the market reacted positively to the decision by the ratings agencies to maintain their AAA ratings on UK debt.

But many challenges face the UK apart from the perilous fiscal position, which will ultimately require more stringent action than implied by the Chancellor's pronouncements. The extra tightening required is likely to take its toll on growth and our pessimism for 2010 is rolled into 2011, where we expect the economy to continue to struggle as raising taxes and cutting spending during an already fragile recovery will be making conditions very tough. Meanwhile, inflation has jumped sharply by the combination of higher energy prices and the re-imposition of a 17.5% VAT rate, but as I said in last month's issue will fall away through the year.

Economic data remained mixed in March. The emergence of the economy from recession helped to boost consumer confidence to its highest level in two years in February according to a sentiment

index commissioned by the Nationwide Building Society. On a gloomier note, manufacturing activity unexpectedly fell for the first time in five months in January, declining by 0.9% from December in a further indication that the recovery remains fragile. Nevertheless official data on industrial production showed a sharp bounce in February after freezing January weather weighed on output and overall activity grew as quickly in the first three months of this year as it had at the end of last year.

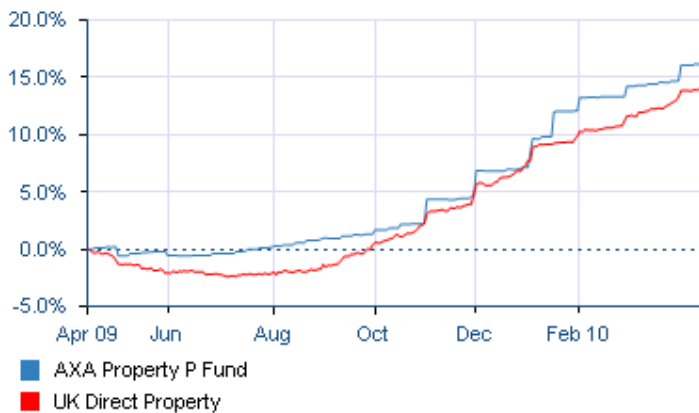
Official data also showed that Britain's services sector did suffer badly in January. But a private survey of the services sector for March showed that for the first quarter as a whole, output of services continued to expand. House prices, too, bounced back in March, recovering much of the ground they had lost the month before, according to one closely watched index, and the Bank of England saw no reason to press on with measures aimed at boosting demand. Moreover, a survey of recruitment agencies showed jobs were added at the fastest rate in 12 years. However the growth in job demand appears to be centred in London, not in the regions, where the government is a big employer.

Conservative pledges to shave £2bn off the public payroll in its first year will hit the regions hardest mostly by not filling vacancies. That means 40,000 fewer public sector jobs. With more than a quarter of the nation's workforce employed in the public sector, those cuts will inevitably weigh on demand. And higher oil prices mean not only higher inflation but also higher costs for business.

European shares rallied in March, as investors became increasingly optimistic about the prospects for Greek debt. The ebullient mood was fortified by rating agency Standard & Poor's which announced that it was no longer contemplating a downgrade of Greece's debt.

Much of the flow of economic data was negative in March. Our views for Europe are that as in the UK growth will be restrained by public sector indebtedness and sluggish personal consumption. It is difficult to see strong domestic demand emerging from within the single currency zone during 2010 as unemployment increases and even the core countries are fighting against larger deficits. Europe seems likely move toward fiscal consolidation.

In a disturbing sign so soon after the onset of economic recovery, the region's growth slowed to a crawl in Q4, rising by just 0.1% on an annual basis. Germany, the eurozone's largest economy, saw exports fall in January for the first time in four months, dropping by 6.3% from December. However, investors shrugged off the gloomier readings, as relief over the debt package overrode any downbeat economic news



We remain marginally positive in property, but the strong gains of the past few months are likely to give way to more modest, returns over the remainder of the year primarily from rental yields which remain attractive.

A gradual rebuilding of exposure in portfolios to the commercial property market is warranted at least until yields on high grade property match those of good quality corporate bonds.

14/04/2009 - 14/04/2010 © Financial Express Holdings 2010

A significant proportion of portfolio performance for the next 12 months will come from yield rather than growth. Retention of higher yielding equities and fixed interest securities will continue to feature in most portfolios, while the gradual reduction in exposure to the UK will also remain in place pending clarification of economic direction which may be delayed if the forthcoming election results in a hung parliament. By then, I suspect we will all be ready to hang the politicians as well!

Steve Patterson - Investment Director