Investment View – July 2010

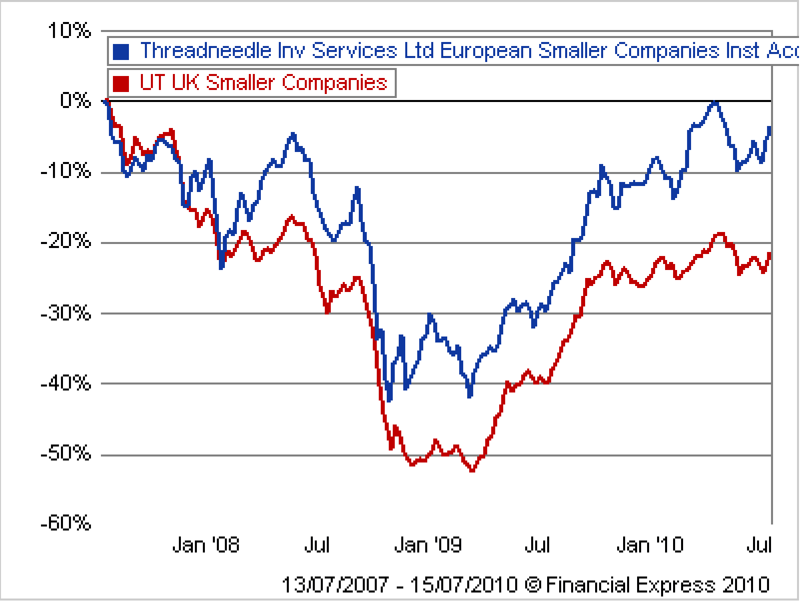
In recent weeks there has been increasing talk of the possibility of “double-dips” in major global economies. Such scaremongering obviously impacts market sentiment and of course threatens to become a ‘self fulfilling’ prophecy, but real evidence to support such concerns is hard to find. Most fund managers are still predicting continuing gradual improvement - albeit at a much slower pace that we have seen over the last 12 months.

We continue to view world equity markets as offering attractive value and there is evidence to support the view that recent falls have been overdone, and that a rebound is now on the cards. The evidence for this is based primarily on technical indicators comparing the yields available from equities to those on corporate and sovereign bonds. These indicate that equity yields appear attractive on a ‘relative risk’ assessment and that (all other things being equal) there is scope for prices to rise.

The US is enjoying the strongest growth of the major economies while in the UK, Europe and Japan the pace remains sluggish as the overhang of debt weighs on recoveries. Under-pinning the US performance had been stronger than expected earnings growth driven by a combination of faster economic recovery, coupled with aggressive cost cutting.

Both these factors have inevitably started to diminish and so the rate of growth in profits will slow, as more recent earnings statements have begun to show. Nevertheless the fear reaction from markets – the FTSE All World Index fell by over 15% from its peak in April – suggests that more than enough profit taking has taken place, and at current levels equity markets look attractive.

Equity markets are obviously affected by investor sentiment, and in the short term the substantial uncertainties caused by worries over sovereign debt in the peripheral countries of the EC, increasing austerity measures in all major developed economies, concerns about the sustainability of the US recovery, talk of ‘double dip’ recessions etc. will continue to mean above average levels of volatility. But for long term investors (such as the vast majority of our own clients) cheap equity prices based on technical measures are good news and present attractive buying opportunities.



Economic conditions in the UK and Eurozone will certainly remain sluggish for some time and within these markets we recommend fund managers with good records on stock selection.

We therefore also continue to favour funds with active investment mandates over ‘passive’ or ‘tracker’ funds. The benefits of diversification through greater exposure in favour of the Eurozone and against the UK have benefited many portfolios over the last 18 months both in the large cap funds and smaller companies as the graph shows.

The major challenge is to shrink deficits by cutting spending and raising taxes. For poorer nations such as Greece and Portugal, this creates real hardship on the population with consequential risks for social and political stability. Consumer confidence is therefore likely to remain quite subdued as the effects of these austerity measures will create a continuing mood of pessimism throughout the whole Eurozone.

Improvements in export markets on the back of a weaker Euro and Pound will be helpful, provided export demand remains healthy. We also anticipate an increase in the level of merger and acquisition activity, both from domestic sources on the back of strong balance sheets and healthy cash positions, and from overseas as a result of favourable exchange rate levels.

In particular there appears to be a lot of evidence that larger US companies are in fairly good health. Consumer spending is being helped by continuing low interest rates and low fuel costs. Nevertheless although the US drives much of its own demand their economy still needs healthy export markets. The scary headlines surrounding the financial stability of smaller European countries and in particular the Greek sovereign debt mania have not helped investor sentiment across the Atlantic.

Emerging markets continue to help portfolio performance and the announcement of a more flexible currency policy for the Chinese is encouraging, as a degree of revaluation will help correct the global trade imbalances improving buying power in the east and thereby helping exporters elsewhere. This more flexible posture suggests that the Chinese are now sufficiently confident of the sustainability of their growth to accept some loss of competitiveness for their exports. A weaker currency would also help to reduce inflationary pressures building up and lessen the need for fiscal belt tightening.

The importance of emerging economies is now looking like a permanent feature on the global economic map, with their combined economies accounting for nearly a third of the GDP of the major trading nations globally. Strength in their economies is good for the rest of us especially if it underpins the gradual improvement being seen in the US economy. We just have to hope that the sum of all these moving parts is that world economic growth will continue even if at modest levels.

Not surprisingly government bond markets have performed well recently as investors have sought shelter from the increasing worries. However the need for high volumes of new government bond issues will peg yields back and in spite of the recent rally in prices our views for most clients' portfolios continue to favour corporate bonds where yield spreads over government bonds have widened again.

The recent retrenchment in corporate bond markets throughout May continued during June, albeit at a slowing rate. Over the month as a whole the average yield margin of investment grade Sterling corporate bonds over gilts rose from 1.90% to 2.00%, breaching the 2009 year end level of 1.94% for the first time and moving well above mid April's 1.49% recent low. High yield bond markets also continued to be subdued.

For UK investment grade corporate bonds this widening of credit spreads was more than offset by the fall in gilt yields on the month, with the FTSE Actuaries British Government 15 years index, falling from 4.05% to 3.88%, the lowest level since October 2009 – implying a return of 2.2% in the month. In contrast Sterling investment grade corporate bonds recorded a return of 1.1% in June.

These moves reflected investors' concerns over the global economic outlook, with the continuing strains within the Euro currency bloc maintaining centre stage. Moreover the pricing and availability of banking finance within Europe appears likely to remain constrained in the near term as the major European banks look to rebuild balance sheet strength and recapitalise their businesses – such action is likely also to be a restraint of economic growth.

Against this backdrop the prospects for the UK economy have improved and appear relatively benign. The UK budget measures were generally perceived as credible and were well received by markets, although there is little doubt that full delivery of projected spending cuts is likely to be extremely challenging. The deferral of a number of measures, such as the rise in VAT, means that any early threat to the UK's fairly insipid economic recovery from recession is allayed.

Finally, commercial property has continued to show steady recover as we had consistently predicted, institutional property funds having achieved unit price gains of around 20% over the last 12 months. Nevertheless the prospect of 'double digit' growth over the next 12 months looks highly unlikely, although rental yields remain fairly attractive relative to other asset classes.

Interesting times!

Steve Patterson - Investment Director