

## Investment View – May 2010

For the first time since the collapse of Lehman Brothers markets across the globe trembled in fear early in the month as the worries of a risk contagion spread through credit markets. The cause was Greece's massive debt crisis, and outright panic was avoided only after the European Union and International Monetary Fund announced an eye popping €750bn loan package to stem the loss of confidence.

Nerves were already frayed by the Friday of the first week after a bizarre mid-day glitch had sparked a massive sell-off in US markets the previous day. An investigation is still under way as to why share prices moved so irrationally - Accenture went from more than \$40 at 2.47pm to 1 cent a minute later - before returning to previous levels shortly afterwards.

By the end of the week the Vix index, a measure of market volatility, was 87.4% higher. The FTSE 100 Index dropped 7.8 per cent, its biggest weekly decline since March with banks suffering the worst on fears that the crisis would freeze wholesale funding markets. The euro and sterling suffered while the dollar and yen soared as 'safe haven' currencies.

Although the hung parliament had been widely predicted, the inconclusive election result increased fears that a new UK government would lack the strength to get to grips with Britain's record fiscal deficit. Gilts were subsequently lifted by the fact that the coalition announced swifter and deeper spending cuts than looked likely in the immediate aftermath of the election.

At a time when we have been consolidating gains by rebalancing portfolios to realign equity exposure after last year's gains, my view is that the UK stock market has become more balanced as a result of the recent sell-off. The FTSE All-Share index has fallen by over 10 per cent since mid-April and now trades on a prospective price earnings ratio of about 10.5, which is well below its long-term average of around 13.

UK equities are therefore not expensive on this fundamental measure, particularly given the improvement in corporate earnings and supporting economic data. UK companies are also sitting on a record pile of cash of just over £140bn which should help merger and acquisition activity particularly if interest rates and hence M&A funding costs remain low.

It might seem counter intuitive but history suggests that sharp spending cuts can actually be a boost to equity markets. Analysts at Goldman Sachs studied the retrenchments of 1977, 1980-82 and 1995-98 and found all three helped UK stocks to outperform. All these periods had seen sharp interest rate cuts and a subsequent weakening of sterling. That makes our exports in goods and services more competitive, and as more than half the FTSE 100's earnings are generated overseas the opportunities are obvious. The Bank of England has supported the new coalition government's robust approach and signalled it was in no hurry to tighten fiscal policy with any increase in interest rates in the near future.

The eurozone managed only modest economic growth in the first quarter of this year, and gross domestic product expanded by just 0.2 per cent. Germany surprised by also reporting a 0.2 per cent increase, in spite of fears that the exceptionally cold weather had stalled its economic recovery. Buoyant business optimism and surging exports have helped Europe's largest economy in recent months and Germany's revival will boost hopes that the eurozone recovery will not be thrown completely into reverse by the crisis over public finances – especially if the €750bn emergency plan succeeds in stopping its spread into a much broader crisis.

The weaker euro already appears to be benefiting eurozone exporters and the European Central Bank last week noted that some strengthening in growth appears to be taking place. Since early December, the euro has fallen by 10 per cent on a trade-weighted basis.

In contrast, the US reported a 0.8 per cent increase in first-quarter GDP developing a strong V-shaped recovery. With the US economy apparently well on the mend its trade gap grew to its highest level in more than a year in March, as rising consumer demand and higher oil prices fuelled imports. America's trade shortfall has grown by 40 per cent in the past year. Although this reflects renewed strength in the global economy and greater domestic demand in the US, the widening gap will provide less of a boost to US growth. The US deficit with China, its biggest and most politically sensitive trading partner, expanded in March, growing from \$16.5bn to \$16.9bn.

Apart from rebalancing to consolidate equity gains since last year's strong recovery the change in emphasis from overseas sovereign bonds to a wider spread of credit risk has also paid off well, for example the switch from Newton International Bond Fund to Schroder International Bond Fund.



The Schroder fund has progressively increased its weighting to the US economy and now carries around 50% exposure. This together with its highly selective approach to credit risk has enabled the fund to achieve significant out-performance against its peer group in the Global Bond sector.

	%
<b>North American</b>	<b>50.25</b>
<b>Europe</b>	<b>29.06</b>
<b>Emerging Market</b>	<b>7.86</b>
<b>Japan</b>	<b>3.86</b>
<b>Money Market</b>	<b>3.55</b>
<b>UK Fixed Interest</b>	<b>3.17</b>
<b>Other Overseas Fixed Interest</b>	<b>2.11</b>

As indicated in previous months' editions of Investment View the emphasis for the time being will remain on yield with a continuing underweight position towards the UK in both fixed interest and equity markets. However if the 'belt tightening' promised by the new coalition government is delivered in practice and the current benign combination of low interest rates and a favourable exchange rate stay in place then the relative attractiveness of the UK should gradually improve.

Returns in the high yield bond sector continue to be attractive, reflecting a growing sense that the risk of corporate default continues to diminish. However it would be unrealistic to expect the phenomenal rise in bond prices to be sustained and at current yield levels the risk/reward balance looks more convincing. In many portfolios there will be a continuing move towards 'strategic' bond funds, where the yield spread will take best advantage of the relative risk and reward covering all sectors from 'junk rated' up to investment grade.

In the meantime while investor confidence has returned to the commercial property market, the improvement in the UK economy will remain gradual restraining any growth in rental income. Nevertheless at current rental yields property could still produce excellent returns this year. However the best returns will rely on good asset choice and a selective approach to taking on greater investment risk. London retail and office properties are beginning to show signs of positive rental growth. Away from this region however, where the economic recovery is more anaemic there is over supply of accommodation and land for development. According to Legal & General its forecasts for the second half of 2010, 2011 and beyond show continued, if modest, growth in values and projected total returns of 8 to 10% for the next five years.

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