



Quarterly Investment Review

July 2010

Prepared in association with our investment partners



Rayner Spencer Mills
Research & Financial Consulting
www.rsmgroup.co.uk

General Overview

The general picture of markets is one of continued uncertainty; there are as many experts in the deflation camp as there are in the inflation camp, indicating the current economic dilemma. Both have reasoned evidence that suggest whichever course the general price trend takes, it will be a very difficult and slow emergence from the current recessionary environment.

Although growth forecasts for the global economy in 2010 have continued to edge up, there is now greater uncertainty about growth next year. Within Europe, many governments have announced cutbacks to the fiscal stimulus programmes they introduced following the demise of Lehman's in 2008. Conversely the US has not used all its stimulus package on the economy and may well use more in the coming months, given lead indicators for economic growth seem to be peaking. This, together with continued growth in the emerging economies, is likely to keep global growth edging forward into 2011. It remains likely however that despite this we will have to rein back the growth figures that were anticipated at the beginning of the year, in particular in Europe. The Goldman Sachs lead economic indicator has very recently been reduced indicating that the peak in growth terms may have already occurred.

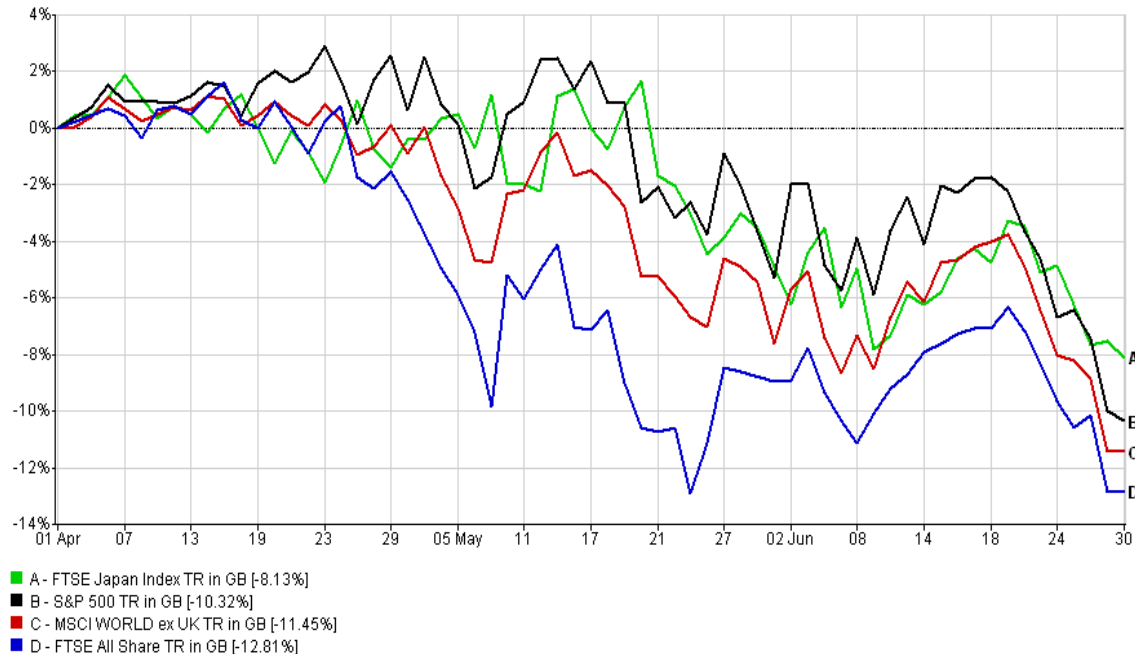
There is definitely a bearish sentiment in the markets currently, based on some technical indicators and the bigger political picture with tightening and austerity being thrown at us from all quarters. There are some redeeming features to this seemingly darkening picture at company level where earnings have remained robust, in particular for US companies and those trading with Emerging Markets. Most corporates have strong cash balances, having successfully cut costs in the early stages of the economic slowdown. The reason for this can be found in the reaction companies had to the financial crisis of 2008. Companies cut hard and fast, quickly reducing their cost bases and stock piles. The restocking process that has occurred in the last twelve months has been done from a much more profitable base. The world has seen a rebound in economic activity and this can be seen when looking at the US ISM Manufacturing New Orders Index. This demonstrated a 'V' shaped recovery. To make sure this is a sustainable recovery we do however need to see an increase in consumption from current levels.

Overall we believe that the likely result of the current position is a very subdued recovery, with many countries recording growth in the range of 1-2% p.a. and this will be especially true within Europe. In this environment interest rates look likely to remain low. It does have implications for equity markets, as very low levels of economic growth can make it difficult for cyclical companies to grow profits. The dangers to this remain at a political and policy level where poor economic management could push the balance towards further recession.

Equity Markets

The last quarter has seen the momentum change in stock markets around the world. Since its April 26th high near to 1220, the S&P has declined 16.2%, ten-year Treasury yields have dropped by about 0.80% to just under 3%, developed equities have dropped by around 14.5%, and emerging market equities have declined by 8.2%, with Brazil and Russia falling by 12.4% and 17.3%, respectively. Since their high in July 2009, Chinese local shares have dropped by 32.0%, while H-shares, those which are accessible to international investors, have dropped 8.5%. In conjunction with these market declines and heightened risk aversion, the VIX index, a measure of market volatility, increased from a 2-year low of 16 in April to a May high of 46 and has now settled near 31 as of Friday's 2nd July close.

Chart showing second quarter returns for major markets



01/04/2010 - 30/06/2010 © Data provided by Financial Express 2010

These are some sobering statistics to absorb given the confidence markets showed in the first quarter of the year. The question is whether we are transitioning from the initial repercussions of a sovereign debt crisis in the peripheral countries of Europe to a global recession in developed economies-- a full blown recession at a time when policy makers have already used all their monetary policy tools (namely, close to zero interest rates and quantitative easing) and have limited or no fiscal policy options (because of already high budget deficits and historically high debt/GDP levels). In addition, exogenous factors, such as the oil spill in the Gulf of Mexico, renewed tensions in the Korean Peninsula and Middle East and the announcement of tax hikes on miners in Australia, have further exacerbated investor concerns.

Whilst the state of the various economies in the world is important in giving direction to markets it is also very much a sentiment driven indicator of individual company's health. We have noted before that this sentiment factor is important in how markets react and that the market is a discounting mechanism reflecting views six to twelve months ahead. This makes for a complex interpretation of what is happening now and potentially in the future. At the moment we can see that this sentiment is very cautious to negative with significant amounts of cash on the sidelines. When looking at influencing trends we tend to look to the US to give direction and cash on US corporate balance sheets, which at about 12% of assets is at the highest level since 1958, or cash in money market funds, which as a percentage of S&P market cap stands at roughly 30%, well above the long term average of 20%.

There are also some technical factors that influence investors thinking and these are pointing in a negative direction. One of these indicators is based on monthly equity prices closing below their 12-month moving average; another - the so called 'death cross'--is based on the 50-day moving average closing below the 200-day moving average. Fortunately for the optimistic of us technical data such as this is not always a good

predictor of market behaviour in the coming twelve months. On two occasions in the recent past when this crossover occurred the market rallied by double digit returns. However, it should be noted that many market participants follow these technical indicators and thus, in the short term, their signals can become self-fulfilling and pressure prices.

In general it is clear that economic data has lost momentum and the lead indicators in the US have started to roll over from peaks. The translation of this for markets in recent weeks has been negative and may well continue for the immediate future but this does not take away from our central belief that these conditions may well slow down growth and cause market volatility, but will not cause a double dip recession to occur. It would be hard to contemplate a profit recession in the absence of an economic recession, particularly given the level of operating leverage and incremental margins evident currently. As we have highlighted before, even slow 1-2% GDP expansion would be sufficient to generate positive earnings growth from current levels.

Sector Review

UK

The UK market has staggered along recently, lurching from the potential contagion of the European crisis and the threat of having its debt downgraded to the removal of the stimulus package and the first announcement of the austerity measures. Any gains made at the beginning of the year in market terms have been slowly eroded by these events. The UK has an over-reliance on its finance sector and it is not clear how long the easing of some of these factors will take. The banking problems are far from over with lending still restricted and global flows of money not back up to pre-crisis levels. The problems of BP have not helped the crisis and this will continue to undermine markets. However at a company level many global exporters have benefitted from the fall in value of sterling.

Europe

In Europe, 2010 has not been a great year so far. The emergency response to the global financial crisis (GFC) has meant government debt in many developed G-20 economies surged. In peripheral Europe, this has resulted in reluctance by investors to hold debt of countries with both high budget deficits and high levels of debt to GDP. Unemployment in many peripheral nations has surged. Part of this problem was not just related to the GFC as many peripheral countries including Greece, Spain and Portugal have become increasingly uncompetitive. This is because unit labour costs have risen, but devaluation is no longer a possibility as these countries are within the Euro block. Interest rates in the UK and Europe look unlikely to increase in the short term and austerity measures will further depress inflationary pressures.

There are still some positives, for example in Germany where the German Ifo index (business sentiment index) actually rose in June and the European Commission Consumer Confidence Index also marginally improved. Considering the austerity measures announced in several European countries and the concerns about the upcoming European banking stress test, even a marginal improvement in a confidence index is noteworthy.

Fixed Interest

Headline interest rates in the developed world are likely to remain low for an extended period – even longer than was thought likely six months ago. Despite this generally positive background, returns from government debt have been varied over the past quarter.

Governments benefitting from either strong finances, or what is considered a reserve currency, have performed strongly. This includes government debt in both Germany and the States. UK gilts have benefitted from what seems to be credible measures to reduce the budget deficit and as a result UK gilts have been amongst the best performers in the world in fixed interest.

In contrast, countries with weak finances have seen bond yields spike higher. This has impacted in particular on peripheral European countries, which have been described as the PIGs. For these countries the cost of borrowing compared to Germany has increased dramatically. Government bond yields in many countries are at historically low levels. Whilst this partly reflects a low growth environment, it also reflects their safe haven status as some investors have used it as a temporary home to park money. A sign of the world moving to a path of sustainable growth is likely to lead to a sell-off in these markets.

Credit markets had a mixed quarter. High yield, which has traditionally had a higher correlation with equities, has performed poorly and so far there has been little differentiation between different names in this sector. Within investment grade credit Financials have performed poorly, as concerns have surfaced over the strength of bank balance sheets, especially in Europe. This has increased funding costs for European banks.

Notwithstanding these issues, the outlook for credit markets remains broadly positive. A low interest world is one in which investors are likely to remain hungry for yield. Implied default rates and valuations look to over-estimate the prospects of default.

A low growth world with extremely low short term rates is a positive backdrop for credit markets. Within high yield, carefully selected names offer prospects of strong returns. It remains an environment where well managed strategic bond funds should be able to deliver strong real returns to investors with relatively low risk.

US

The US market is the only major Western market which is trading a little above fair value, however, this is the economy which looks to be enjoying the most robust economic recovery and strongest earnings growth. Historically investing in the US market at fair value has given returns of approximately 9% p.a. The US starting PE is not high enough to suggest investors in the US face insurmountable issues.

Unemployment data and sentiment indices are now showing weakening trends however it is common at this stage in any recovery that trends slow down and it is difficult to identify whether this is more than a blip. The world economy certainly needs a strong US economy to lead it out of further recessionary pressure.

Asia and Emerging Markets

Asian markets have performed strongly over the last 12 months, as doomsday prophecies on company profitability did not come to pass. Economic fundamentals in the region remain by and large stronger than the West. Following the 1998 Asian crisis Governments have put domestic finances on a much sounder footing. Interest rates within Asia remain tied to US monetary conditions and as a result they look likely to remain loose for both 2010 and 2011. As a result following a powerful rally, valuations have gone from cheap to around historic averages and delivery on earnings is likely to be a key market driver at this stage of the cycle. In the event of a significant global slowdown, Asia is in a position to self help with further fiscal stimulus. There are already indications in China of less aggressive tightening of monetary conditions, as the property market slows. Firm evidence of an end to tightening by the Chinese authorities would be a catalyst for a significant market rally.

The emerging world has not suffered the same level of crisis as developed countries. This area of the world is less policy constrained and will be an important offset to slower developed world growth.

Although emerging markets have historically been viewed as volatile by investors, this is more a reflection on the makeup of the MSCI EM Index, rather than domestic growth prospects. Many of the leading companies in this index are tied to the global export cycle and US consumer. Thus investing in the index can give investors a high beta play on the US and western consumer. This is why emerging markets often record severe losses at times of global economic stress.

Within these regions there are a number of funds that can be utilised to benefit from the domestic consumption story. These typically buy low beta economically insensitive stocks. These are companies producing what in the west are described as basic consumer staples with low growth prospects. However, in the emerging world increased consumption of consumer basics looks a given, as both wage levels increase and the population grows.

Japan

Japan has seen an export led recovery, benefiting from its proximity to China and other dynamic economies within Asia. This is positive for operating rates and profitability, which is expected to show a strong rebound in the financial year to March 2011. There have been some signs of stirring in the domestic economy, although deflation persists. One potential negative for the market would be if the Yen continued to strengthen further. If this continues estimates of profitability may turn out to be too high.

The Japanese market has been slow in the recovery phase of the market and does appear under-valued, however, this remains a deflationary economy where domestic demand is still fragile

Property

Within the UK, yields on prime properties (well-located assets that generate a strong rental income) are stabilising, having contracted significantly since the summer of 2009. Income remains a primary driver of returns in commercial property.

Whilst demand for yielding assets continues to be strong, overall rental growth remains subdued. Funds with low vacancy rates are likely to continue to deliver positive returns, although these will be more muted than over the last 12 months.

Summary

The conclusions of the review based on the current economic data would lead us to remain cautious about the state of the recovery. There is some consensus that we have seen the peak of the current phase of growth and there is a decline in leading indicators pointing to a reduction in growth assumptions for 2011. This is however very much a reduction in growth rather than a move to a double dip recession. Despite some ominous Sovereign debt positions, the company led information flow seems quite positive in terms of profit expectations but again unless this is backed up by some increased consumer activity then the positive position may slow down. In terms of markets, company valuations seem below fair value in most western markets leaving some room for re-valuation but at the moment negative sentiment is having a greater influence keeping cash on the sideline.

The recent fall in markets and increased uncertainty has shown us that we need to be wary of assuming this is a normal economic recovery. Recent studies have shown that financial crises generally take longer to absorb than other types with unemployment and government debt staying higher for longer. There are some positives that will reduce the effect of this including the rise in Emerging Markets and in particular China in terms of sustaining and building growth.

We think it is right for investors to remain defensive until further clarity is given on some of those political and economic factors causing the uncertainty. Relative to other asset classes it still seems that equities have the greatest scope for revaluation and that once again dividends will play an important part of investors returns (possibly more than half) over the coming 12-18 months.

Ken Rayner

Rayner Spencer Mills on behalf of Griffins Financial Solutions Ltd

July 2010