

outlook

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World Markets

Don't ignore the elephants

Global markets closed the year at levels close to their pre-Lehman highs, as Central Bank liquidity triggered a massive rerating of equities that by late 2008 had priced in the worst of outcomes. Economic forecasts for 2010 have been steadily revised upwards, but there is a long way to go before we return to the 2007 peak in Western GDP. We are now seeing a pronounced deceleration in the rate of improvement of leading indicators, reflecting the waning impact of the stimulus packages and the inventory swing, and pointing to a loss of economic momentum by Q2 2010. Bank lending remains weak, as households continue to degear. Western governments, faced with soaring deficits and debt/GDP ratios, are contemplating years of austerity budgets, even if they disguise this under the name of “efficiency savings” – the last refuge of the scoundrel after patriotism. This combination of low growth, weak lending, household degearing and austerity budgets could put pressure on corporate earnings, especially given the record high levels of surplus capacity in both labour and equipment across the world. Furthermore, the room is full of elephants that everyone is ignoring, but which could disgrace themselves at any time. The debt débâcle in Dubai and the downgrading of the Greek credit rating are likely to be followed by refinancing problems with US and UK commercial property loans. The US is busy

stoking up another sub-prime crisis, this time funded by Ginnie Mae, rather than Fannie and Freddie. Cheap money has also encouraged companies and their bankers to issue the same types of low-grade debt that contributed to the current crisis. It is clear that the buyers have learnt nothing from the crisis and deserve to be burnt again. The debt problem has been transferred from the private to the public sector; the USA, UK and Eurozone issued \$3945bn in government bonds in 2009 – up by 86% yoy. 2010 could see record government debt issuance at a time when their Central Banks are debating their exit strategies from the liquidity they have created. If issuance and exit are badly coordinated, financial markets could be in for a bumpy ride. Government bond investors are beginning to signal their unease, with yields rising in the UK and US. Even though we do not expect a resurgence of inflation, government bonds could suffer from oversupply. A falling US trade deficit means fewer dollars for China to invest in US Treasuries. Corporate bonds will remain more attractive than government bonds this year.

The “noughties” has been an unrewarding decade for Western equity investors, and it might be hoped that mean reversion will generate above average returns in the current decade. In the short term, however, we are cautious, given our outlook for the Western economies. Valuations have recovered from their fire sale lows and while they remain below their long-

term averages, this reflects an appropriate recognition of slow economic recovery and the risk of a badly handled exit strategy. Total returns will be far more pedestrian than in 2009 – we would guess at perhaps 10%, and probably achieved in the first half of 2010. The withdrawal of liquidity will lead to the underperformance of the low-quality shares that drove markets last year. Furthermore, dividend income will play a far more significant role in total returns. Finally, growth will be largely confined to emerging economies. To capture these trends portfolios should focus on quality blue chips with secure cash flow and a strong international presence. These are precisely the shares that constitute the bulk of the leading indices. Emerging markets have performed particularly well over the past year, but we continue to recommend a progressive increase in exposure to this asset class over time. A portfolio weighted according to the PPP GDPs of the top 15 developed and the top 15 developing economies with investable markets would already have 41.5% in emerging markets! Finally, although gold has weakened with the recovery in the dollar, it remains an important part of our recommended portfolio, not only as an insurance policy and a portfolio diversifier, but also as a commodity with exceptionally favourable supply/demand characteristics.

USA

M&A the key to performance

Despite recent optimism, the recovery remains weak. Although the number of planned job cuts fell to a 2-year low in November, and weekly job losses are declining, there is no sign of an actual recovery in employment. The economy needs to create 100-150,000 net new jobs a month simply to absorb the number entering the workforce. The individual states are facing the largest budget deficits in their history – an estimated \$162bn for fiscal 2010 – which they are required by law to close, and can only do so by cutting services and employment. The Chicago Fed National Activity November Index showed that the economy was still in recession, and it now appears to be losing momentum. The manufacturing PMI for November weakened, while the Services PMI showed the sector is contracting again, and the employment index was particularly weak. Investors have been pinning their hopes on a recovery in the housing market, but Freddie Mac forecasts that mortgage rates will rise from a current 5% to 6% by the year end; if true, this may send the housing market and the lenders into another tailspin. Given the healthy state of US corporate balance sheets, however, 2010 could be the year of sharply increasing M&A activity, which should underpin the market, despite the above uncertainties.

UK

Pre-election budget

The Chancellor delivered his latest exercise in speculative fiction, known as the pre-budget statement, in which only bankers suffer, and where hard decisions about cutting the deficit are comfortably kicked into the long grass the other side of the May election. Out go Prudence and the

Golden Rule; in come electoral politics and impossibly optimistic growth forecasts. The rating agencies are not happy, and the UK could face a ratings downgrade if the election fails to deliver a more hairshirt budget along Irish lines. Sterling is weakening, and gilt yields are rising.

With the manufacturing sector having shrunk at an unprecedented rate over the past decade, there is little scope for improving the trade position, which continues to deteriorate; the consumer refuses to capitulate, even though he is reining in debt. Indeed, the strength of retail sales is remarkable, given the rise in unemployment. The final GDP revision showed that the UK was still in recession in Q3, with a qoq decline of 0.2%, but with a better balanced economy. Construction, utilities and services data were revised up, business and financial services down. The most encouraging news was the rise in savings ratio to 8.6%, the highest since Q1 1998, reflecting a 5.2% yoy rise in real household disposable income. Given that earnings were under pressure, this must reflect the fall in average mortgage rates from 5.8% in September 2008 to 3.6% in September 2009, and the temporary cut in VAT. An austere economic outlook has not however upset equity investors who are well aware that 60% of FTSE earnings derive from outside the UK, that valuations are attractive relative to Europe and the USA, and that the current weakness in sterling will further inflate overseas earnings. Politics, and the risk of a hung parliament, will be a growing theme this year.

Europe

Euro overpriced

The persistent divergence between the economies of France and Germany and those of Ireland, Spain and Greece is

weakening the Euro, which had been propelled to unsustainable levels. Even in the former, employment has been cushioned by government subsidies at the cost of a serious rise in unit labour costs. We expect unemployment to continue to rise through 2010. Export orders are recovering, but the ending of the €5bn German car scrapping scheme – ten times that of the UK – will cause a decline in new registrations. Despite the reasonable 2010 PER of 12.6 (ex-financials) the region is becoming less attractive to investors, given the sluggish growth prospects, although we could be surprised by an upsurge in M&A activity this year.

Far East

Not quite as good as it looks...

Industrial output is rebounding in Japan, and steel production is forecast to rise by 51.9% yoy in Q1, but this paints too rosy a picture of the economy, which is still in a state of deflation. Total cash earnings fell by 2.8% yoy in November and the ratio of jobs to applicants is still only 0.45. The government has released its forecast for FY 2010-11, where it projects real GDP growth of 1.4%, but with the economy still in deflation. Equities have rebounded as the Yen has weakened by some 9% from its high vs the US\$, but we are becoming concerned about the increasing difficulty of refinancing the budget deficit, given the lethal combination of record borrowings and record low household savings ratio. China's manufacturing PMI reached a 20-month high, and its recovery is certainly benefiting countries in the region. Despite the rise in Indices in 2009, valuations are not excessive, but withdrawal of excess liquidity in China could restrain equity performance later this year.

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