

GLOBAL INVESTMENT STRATEGY – SUMMARY

Economic & Financial Market Background

In the last few weeks, concerns have grown over the prospect of a looming European debt crisis. For financial markets this has overwhelmed the continued encouraging economic newsflow being reported around the world and culminated, in recent days, in a mini-panic in financial markets with investors returning to the security of high quality/safe-haven assets.

Beginning with the economic background, recent data indicates that the global economic recovery, which began in the middle of last year, continues to gather pace. While Q1 GDP reports may lag the growth pace of the prior quarter, much of this is due to the impact of the severe winter weather experienced in the US and Europe.

Cyclical recovery in the emerging world has been a reality for some time but in the advanced countries GDP growth is recovering at varying speeds. Even so, the quality of growth is improving i.e. private domestic demand is beginning to contribute more to GDP growth while unemployment appears to have peaked and income gains are turning positive. These are trends that need to be consolidated if the global recovery is to become into a self-sustaining expansion.

An increasing number of commentators, while pointing out the ongoing risks, are indeed recognising the likelihood that just such a transition is underway. The IMF, for example, whose forecasts have lagged those of the major investment banks for some time, recently revised its 10 forecast substantially higher in the latest edition of the “World Economic Outlook”.

As noted, so far the recovery remains uneven being led by a strong advance in Asia, above trend GDP growth in the US and Japan but only a very modest recovery in the UK and Europe. The US has just reported Q1 GDP growing at a 3.2% p.a. rate, supported by strong advances in consumption and capital spending on equipment and software. These are the areas of the economy where growth is essential for a sustained expansion to develop. More recent data points encourage the belief that this is underway with further strong gains reported by leading indicators, such as the latest ISM survey, while the US employment report was especially encouraging.

The positive message being delivered on the acceleration in growth is being reinforced by PMI's (business confidence surveys) around the globe all signalling a strong upturn in final demand and a broadening in the base of growth. This is particularly true for the UK and Europe where, after a slow start to the year, the surveys are universally pointing to economic activity advancing at a 2% to 3% pace, a rate of growth most forecasters have pencilled in for the rest of the year.

Growth rates in Asia, continue to be revised higher and while there are concerns that the pace of activity in China needs to moderate, before overheating becomes a problem, progress in Japan and most other countries in the region is highly encouraging.

Despite these higher levels of growth, inflation remains well behaved in most countries and while some in Asia, particularly China, are beginning to modestly tighten monetary policy in the developed world interest rates are expected to remain at current levels for at least another 3 to 6 months.

So, in some ways it may appear a little abstruse that against an economic background that is evolving in a way few even dared hope for that another financial panic has unfolded. As has been consistently noted in the main GIS/AA documents, however:

“Generating an economic recovery in the developed world has entailed considerable cost, not least the ballooning in central banks’ balance sheets and accumulation of massive fiscal deficits. The unwinding of these is likely to be gradual and carefully planned but their execution adds to the risks of successfully transitioning from recovery to sustainable expansion. With risks still higher than normal and further shocks possible the economic outlook is more uncertain than indicated by the general headline forecasts of sustained global growth in excess of 4.0% p.a. for this year and next”.

At this stage, it is difficult to judge how much macro-economic damage will permeate from this fiscal crisis. It is centred on Europe but in real terms, Greece, Portugal or even Spain for that matter, have barely any influence on existing forecasts for eurozone growth. Perhaps a more pertinent issue is that the strong global recovery and (hoped for) transition into sustained expansion was predicated on the view that the link between growing economic and financial market confidence would persist and strengthen. That this is under threat, of course, is a major concern.

At the moment, the implications of the Greek rescue are being transfused into more general concerns about sovereign risk and it is contagion that is causing a pullback from risk assets. Ironically, bond yields in the US, UK and Japan have fallen sharply and yet all have more serious fiscal positions than the eurozone as a whole. The MSCI World Equity Index has fallen by nearly 10% from its peak in mid-April but obviously Europe has suffered more, particularly because of the potential impact on the European banking system and the very high content of financials in the main stockmarket indices (around 26% at end Q1). The UK has had the added uncertainties of an election and a hung parliament so both the stockmarket and currency have suffered. Indeed, in common currency terms since 20th April, UK equities have underperformed the rest of the world by nearly 6%.

How this latest financial panic will play out is obviously a matter of some debate. The view is that the ECB will introduce exceptional measures that will back up the European authorities’ claims that they will “use the full range of means available to ensure the stability of the euro area” and will “preserve financial stability in Europe”. This action must be sufficient and swift enough to restore calm/stability to financial markets especially in the light of the timescales and prevarication in agreeing the €10bn rescue package for Greece.

For now, most commentators believe that the sell-off remains a correction, and although there is scope for conditions to worsen markets should rally smartly if the ECB/EU is seen to be tackling the key issues by ensuring sufficient system liquidity and a support programme of bond purchases in fiscally troubled markets. No matter what occurs, however, fiscal problems won’t melt away, they will be central to government and central bank policy-making for a considerable time and, now that the debt genie is out of the bottle, it will be incumbent upon policymakers to cut deficits more swiftly and aggressively. Greece has provided the first example of the implications of lost financial market confidence, and surely others will seek to avoid this at all costs.

Looking forward Looking forward our asset allocation views are:

- It has long been noted that 10 would likely prove to be a more difficult and unsettled year for equity markets, although positive returns were and still are expected. With world economic growth forecast to be fairly strong through much of the year, the major issues centre on government and central bank exit strategies both of which have the potential to cause substantial volatility. Evidence of this has occurred with monetary tightening in China resulting in substantial local equity market underperformance while, more dangerously, bond markets have forced far faster and more radical deficit reduction on Greece and contagion has spread to other countries, particularly in Southern Europe, raising more general concerns about global fiscal debt sustainability. Given these risks, equities need to be attractive to investors and, as long as economic and profit expectations are met, then valuations are cheap, especially relative to cash and bonds. Interest rates are set to stay low for some time to come and global economic news could still surprise on the upside. Europe has already

underperformed significantly but the US may act as a “safeish” haven for a while longer. Otherwise there is little to choose between the main geographic areas although currencies may play a larger role in returns. Investors will need to be opportunistic, however, and should favour a barbell of good value, defensive growth stocks, high yielders and industrials all with exposure to growth markets. In the short term markets should soon begin to find some support. The scale and speed of the fall in equity markets, taking many back to six to nine months ago levels, has been enough to move them from being overbought to oversold and bargains are beginning to appear.

- Leading bond markets have rallied hard in recent weeks as investors have rushed back into what in the past periods of financial crisis, have proven “safe havens”. Quite how safe they really are, on a longer-term view, given the scale of deficit/debt problems is, however, another issue. Unless the fiscal panic in Southern Europe causes far greater damage than most commentators currently expect, then current yield levels can hardly be described as good value. We have long noted that the scale of spread tightening in corporate bonds in the UK had resulted in greater vulnerability to a setback but any substantial widening should be used to re-enter trades.
- Newsflow in UK commercial property continues to improve. Industry specialists have been joined by investors reinvesting in a sector where the yield pickup is still 3.0% above 10-year gilts. A shortage of prime property is squeezing prices sharply higher at the moment but as 10 progresses higher capital values should encourage involuntary holders, such as banks, to further boost supply. Even so, with in excess of double-digit total returns forecast for 10, property should comfortably outperform cash and government bonds. Property shares have underperformed since last summer and there could be some relative upside on a longer-term perspective.
- Predicting commodity returns is always a difficult call given the very broad spread, high volatility and problems associated with rolling over futures contracts on returns. Near term, prices are under considerable pressure as investors desert risk assets but this is likely to last only as long as the current financial turmoil. As long as the global economic background develops as anticipated the favoured commodities, such as oil and copper, where there are clear long-term demand/supply imbalances, should hold up. Valuations of the major diversified miners have improved considerably and the sector is likely to lead any bounce in stockmarkets.
- The euro will bounce on the announcement of a support package but debate over its long-term future will continue. While weak year to date, it should be remembered that the euro, like the yen, has performed very strongly on an effective exchange rate basis for some considerable time. Fundamentals continue to look poor for all the major currencies, but in relative terms the dollar may continue to perform well while sterling may seem “cheap” but near term will be at the mercy of political developments. Our long held and long-term conviction that many emerging and commodity currencies will substantially outperform remains in place.

Andy Brunner

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