Market Commentary

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Steady as she goes

Investment markets remain resolutely nervous. This, though, is a thoroughly good thing and means that we can continue our long-standing strategy of cherry-picking exceptional value as and when prices fall, rather than the alternative of having to chase runaway prices upwards. The latest bout of the collywobbles has come from Ireland, which has followed Greece into the euro crisis locker. Whether or not this was justified will be argued over for many years, but the timing in taking the wind out of the sails of the optimism that had built over the previous couple of months was fortuitous. The damage done to global equity markets has been very slight, while bond markets are reacting more to the Federal Reserve Bank's expansion of the American programme of quantitative easing and the heightened risk of inflation that this brings.

The markets are still prepared to back neither inflation nor deflation as the more likely course of events with any conviction. The reaction to the Federal Reserve's announcement of its trillion dollar extension to its bond purchase programme was to buy equities and commodities, but this was no more than a minor swing in the relative valuation of asset classes and has already unwound slightly. There is an additional factor here that as we near the end of what has been a highly challenging but ultimately rewarding year, fund managers will be looking to bank the returns that they have made rather than run the risk of seeing these evaporate during December.

Equity and bond markets are still telling us different stories. The low bond yields, especially in the UK where they are well below the rate of inflation, tell us that something akin to Japan is the most probable outcome for the developed world. Equities, on the other hand, are in neutral territory and look fairly valued against a scenario of steady but positive growth. We do not see this conundrum changing until it becomes clear whether or not the American quantitative easing programme is working and raising inflation; given that this is not due for completion until June 2011 and the effects will not be seen until the middle of 2012, when we should expect that next year will give us more of the same. The markets will react randomly to each incoming data item as we swing from the need to protect against higher inflation to scares of deflation.

We are worried that we are falling into the habitual industry trap of explaining what has just happened and to use this as the basis for forecasting the next year; these swings will not be the only factor in play and others will inevitably develop. We may see more euro crises unless the ECB and European governments actually get to grips with the whole situation, we may see a sharp slowdown in emerging markets, we may see soaring company profits and a new mergers and acquisitions cycle. But our core expectation is that 2011 will look much like 2010 and we go forwards into 2011 targeting returns in high single digits. Our aim is that any extra returns from better markets should be treated as a bonus.

There are many grounds for believing that 2011 will be another ultimately successful year for the UK equity market. Dividend growth is increasing nicely regardless of what does or does not happen with BP's payment, backed by high earnings cover, good cash generation and generally strong balance sheets. Crucially, the confidence for companies to act in a more shareholder-friendly manner is coming from steadily improving trading conditions. Indeed, with the exception of the house-builders, it is difficult to find any sectors where we are not seeing improvements in both top and bottom lines. There are some issues with the public sector facing outsourcing businesses, but even these are speed bumps rather than u-turns.

The direction of the FTSE 100 is still mostly determined by the miners. The significance of this is that we are seeing market gains despite the persistent underperformance of the banks and the lacklustre performance of the pharmaceuticals. The 100 Index, though, disguises that the broader market has been much stronger. In the year-to-date the 100 has added less than 5% while the 250 is 16% up. This is a very significant difference, which interestingly is mirrored in the US where the S&P 500 is 7% up in 2010 versus over 18% for the Midcap 400 (all data: source Reuters).

Our fundamental equity research process has been a consistently reliable guide to over and under valuation in the market. With the FTSE 100 trading in the 5700 to 5800 region we have been finding it increasingly difficult to find stocks that we can recommend. This reverses very quickly however when the market drops back closer to 5500. If we now take roughly 5600 as our starting point for our 2011 expectations, a total return of 10% for the year equates to year end expectation of close to 6000, assuming a 3.5% dividend yield and no change in the p/e ratio.

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Despite our conviction in the long term growth and merits of Asian emerging economies in general, we have some shorter term concerns over the relative news flow. The levels of optimism are excessive and the positive stories well known. The long standing discount rating of emerging markets has faded, whereby p/e ratios are now in line with developed markets. Emerging markets, led by India and China, are in a monetary tightening cycle, while the developed world, led by the United States, is again loosening. Moreover the US is introducing more quantitative easing at a time when many of its economic data are taking a turn for the better. We are thus mindful that we may well see better buying opportunities for those wanting or needing to top their weightings in emerging markets.

Gold is still the asset for all seasons. Not only is underlying demand from the Indian jewellery industry rising but the mellow yellow metal is seen as a hedge against the end of fiat currencies (exceptionally unlikely), a falling dollar (which depends where you are on the other side of the deal), a rising dollar (ditto), higher inflation (which defies logic) and deflation (marginally less tenuous). While we also know that the increased liquidity in gold will mean that it correlates with everything else if we see another dash for cash, we retain our weightings for the time being for the shorter term diversification benefits.

Finally we would like to take this last opportunity in 2010 to wish everyone a very happy Christmas and a prosperous New Year.

Jim Wood-Smith
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