Market Commentary

February 2011

WILLIAMS DE BROË
SINCE 1869

The nuclear option

The speed at which markets can shift direction is a constant source of amazement. It was only last autumn that the great fear was that the western world was following Japan into a multi-decade period of low growth and persistent deflation. Debts had to be repaid, it was argued, and the only way for this to be done was slowly and steadily. And until this was done there was no basis for a resumption sustainable growth in the UK, United States or Europe. But now this is all forgotten. Markets are instead abuzz with inflation, food prices, commodities and the timing of interest rate rises. There are no guarantees that this phase will last any longer than the previous Japanese obsession and we expect that these sudden and severe changes in sentiment will characterize the year ahead. We thus retain our diversified strategy, leaning towards a cyclical recovery but not to the exclusion of any other potential eventuality.

The trends in markets we are seeing in the early stages of 2011 can be traced back to the announcement of the restarting of quantitative easing in the United States last autumn. Since that time we have seen investors globally rebuilding their protection against inflation; prior to then the relative valuations of equities and bonds showed that deflation was seen as the greatest threat facing markets. UK equities yielded more than gilts for the first time since the 1950s, other than at the bottom of the market crashes in 2003 and 2009. This time it was not the result of the text book irrational selling at the bottom of a crash, but came instead from the lowering of bond yields. The Federal Reserve Bank's insistence however that it will add up to $1 trillion to its purchases of treasury bills has shaken investors' confidence in these extreme valuations. Almost to the day of the announcement we have since seen equities given renewed life, commodities surging, bond yields rising and gold underperforming.

Increases in food prices and soft commodities are happening also because of poor climatic conditions around the world. Shortages in a number of key foods can be traced back to the Russian heat wave and fires last summer, through to the current flooding in Australia and drought in large areas of South America. Most recently the United States has indicated that its stocks of wheat and soybeans are at their lowest for 15 and 40 years respectively (source Reuters January 2011). There is no doubt that these price rises will result in the reported rates of inflation increasing around the world very rapidly throughout the first half of the year. Additionally the price of oil has been rising steadily, recently exacerbated by the unrest in North Africa; here in the UK increases in duties are making the problem worse. Mervyn King, the Governor of the Bank of England, has warned that the consumer price index is likely to reach 5% in early 2011, more than twice the level that the Monetary Policy Committee (MPC) is mandated to achieve. Unfortunately the MPC has only one weapon at its disposal, interest rates. It may argue that the factors driving inflation higher are food and energy, both of which are outside of its control, and the planned public expenditure cuts and tax rises this year are already imperilling the fragile recovery. The pressure on the Committee to raise interest rates will only intensify as the year progresses, but its potential use of higher interest rates is akin to attempting crowd control with a nuclear bomb.

Other economic indicators are remarkably benign. Manufacturing data from around the world, and in the United States in particular, is very strong. One credible explanation for this is that the economy has completed a phase of restocking, after inventories were cut to the bone in the aftermath of the 2007-09 crisis, and is now instead reacting to genuinely better end user demand. Though much of this demand is coming from emerging markets there are also good reasons to believe that western economies are also strengthening. The US Services ISM for example recorded its 14th consecutive month of growth in January and is growing at the fastest rate since this particular data series was started in 2008 (source Institute of Supply Management February 2011). The picture is complex though and is still not backed up by either the labour or the residential housing markets, both of which remain stubbornly resistant to all attempts to help.

The civil unrest seen initially in Tunisia and latterly in Egypt has reminded the investment world of some of the risks associated with investment in developing countries. 'Emerging markets' have been viewed as the financial equivalent of a free lunch and have attracted vast investment inflows. Experience teaches that at times like this something unforeseen is inevitable; this time around it is political risk. The reaction thus far however has been remarkably measured and we are not seeing a wholesale flight to safety, despite a small dip in global equities and an accompanying rise in the price of gold. We were rather

Market Commentary

more concerned by the response to China's announcement that its GDP grew by 10.3% in 2010. This is slightly higher than had been expected, but is nonetheless within a few percentage points of its long term average. That equity markets fell on this news suggests to us that fears of overheating and inflation in emerging markets are growing and are likely to become more prominent over the first half of this year, especially as food prices continue to rise. Food typically plays a much more important part in the calculations of inflation in emerging rather than developing markets and it is most unlikely that we have seen the last of either the market's concerns or public demonstrations as a result of unaffordable basic foodstuffs.

Corporate profitability has remained impressive. Companies the world over are reporting steady growth not just of post tax earnings but also increasingly of revenues. The challenge as 2011 progresses is whether or not companies will be able to pass on rises in input costs (from more expensive raw materials) or whether they will have to absorb all or part of these in their margins. Perversely the latter scenario is probably the healthier for markets in the long run; a softer labour market means less upwards pressure on wages and thus less need to raise interest rates. We expect that acquisition activity will be high this year and we are especially encouraged by prospects for dividend growth. A number of companies, most notably BP, have resumed payments to shareholders after hoarding cash throughout last year. The aggregate levels of cash on company balance sheets is extraordinarily high (source Evolution Securities January 2011), suggesting that in these days of negative real interest rates, this will either be returned to shareholders via a variety of means or else used to fund expansion. Both of these should be very positive for equities.

We continue to tread warily, preferring to add money to the markets on weak days, or weeks, or months, rather than chasing prices upwards. But the odds are shifting in favour of a third consecutive profitable year rather than a return to 'double dip' and recession.

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