

Measured progress

There is much to be gleaned from the performance of markets over the first quarter of 2011. Ever since equity markets hit their most recent low point in March 2009 many have questioned the rationale for and the resilience of the rises in global share prices, arguing that markets were in denial about the continued parlous state of Western economies and their financial systems. Over the early stages of this year however, markets have withstood the very considerable headwinds of high inflation in both developed and developing economies, tightening monetary policy across most of the world, an oil price at near record levels, widespread civil unrest across much of North Africa and the Middle East, plus the Japanese tsunami and associated radiation leaks. A mere twelve months ago it would have been inconceivable that markets could have absorbed all of these with barely a wobble; but despite the Japanese Nikkei Dow Index registering its worst two-day fall since the crash of 1987 in the immediate aftermath of the Fukushima nuclear incident, that is what we have seen. This shows a large and significant increase in confidence.

In many ways this has been a very old fashioned start to the year. America has taken up the running in terms of both equity market performance and economic growth. With the notable and considerable exception of the housing market, the world's largest economy is in robust health. The two key monthly indicators of economic activity that we use, the Institute of Supply Management surveys for both Manufacturing and Services, have been showing impressive growth for many months. Importantly the most widely used measure of employment, non-farm payrolls, are at long last registering steady if unspectacular job creation and the rate of unemployment has fallen below 9% (source Bloomberg). The one remaining cold spot is the housing market. Sales of both new and existing homes are at rock bottom levels and, although the magnitude is still small, average house prices have fallen for the past seven consecutive months (source Bloomberg). It may be that housing will be the last domino to rise in this economic cycle; affordability is the best for a decade and employment is rising, but neither will drag prices upwards until the overhang of oversupply is dealt with.

It is also traditional that rises in equities should be viewed with a strong scepticism. We should draw comfort that so many commentators believe markets are 'defying gravity' or

'ignoring the real world'. These are the bricks that make up the 'wall of worry' markets are said to climb, and so long as these concerns remain we should be confident that we are still in the relatively early stages of the cycle. The time for investors to fret is when everyone believes that markets are going to rise and that they understand the reasons why. We are nowhere near this attitude yet and the broadly sideways move in the major equity indices over the course of the first quarter this year, after such a strong end to 2010, is a healthy consolidation in a long bull market.

In contrast, the bond markets are looking considerably more nervous. Prices have fallen and yields risen in response to the nagging increases in global inflation. The UK may be the starkest example, where the February measure of the Consumer Price Index (CPI) showed an annual increase of 4.4%, more than double the 2% target. The Monetary Policy Committee has also let it be known that CPI is likely to hit 5%, sooner rather than later, and it is now a matter of how quickly and how aggressively monetary policy is tightened in the UK, Europe and the United States rather than there being any lingering hopes of extensions to the quantitative easing programmes. Bond yields in general, and especially gilts, have been artificially low since the beginning of the quantitative easing programmes; the rises that we have seen in the year so far should be taken as an overdue dose of normality, a rational reaction to the heightened inflationary risks. We are however more sanguine than many about prospects for interest rates, believing that many of the factors driving inflation up, especially energy and commodity prices, will naturally work their way out of the inflation calculations towards the end of this year and into 2012. On this basis any further significant falls in bond prices would present an opportunity to lock into potentially attractive yields. Even if we are wrong in our assumption that the UK bank rate will not be raised this year, this should not be a cause of great concern. Equity performance is typically very strong during the early stages of a tightening interest rate cycle, with this coinciding with the fastest corporate profits growth, while bond markets should eventually react positively to the anti-inflationary strategy.

Both debates – on equity performance and bond yields – highlight the difference between the domestic economy in the UK and the stock market. The former is still struggling. The public sector job cuts, tax rises, persistent inflation and



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tight credit markets have contributed to a scenario whereby the February level of the Nationwide Consumer Confidence Survey was lower even than at the worst of the 2008/09 banking crisis (source Nationwide). This has been echoed by many retailers, where company after company has reported that trading conditions, which were already poor by the turn of the year, have worsened even further in the early spring. Nothing though is ever black and white and it is very interesting that the house builders have been surprisingly optimistic about their crucial spring selling season. The performance of the equity market however has precious little to do with our economy. Instead it is international markets, and especially emerging economies, that drive equity prices. The market is dominated by global businesses; as an example the mining and oil sectors alone account for more than 30% of the FTSE 350 Index of our 350 largest companies (source Reuters).

Economic growth in China, India, Brazil and in developing economies in general has continued almost unabated by their tighter monetary policies and, despite the strong US economy that we mentioned earlier, is the primary driver of global equity markets. This has also been seen in the performances of individual stocks over the first three months of 2011. Marks & Spencer (which after John Lewis is still the bell-wether of the UK consumer) has seen its share price drop near 10% since the start of the year, whereas BG

Group, as an example of an international resource stock, has risen by over 15% (source Reuters). We suspect that this stark divergence will muddy as the year progresses; markets are paying a rich premium for growth, a trend that is likely to result in buyers being attracted towards the value being uncovered in the more lowly rated domestic stocks. It is highly likely that we will see the already high pace of corporate activity accelerate further, part of which will entail the re-emergence of private equity buyers seeking bargains amongst the underperforming and cash generative domestic industries.

Our strategy remains that of diversification and moderation. Our hopes for returns from our equity holdings may have risen slightly during the year so far, but not with sufficient confidence to wish to raise our allocations. We are looking for 2011 to be a third year of good returns, again led by growth in the developing economies, but volatility will remain high as sentiment oscillates. As with last year, the greatest risk will be in trying to follow the short term swings of outrageous fortune that always characterize investment markets; the greater and less volatile returns will come to the patient.

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