Economic and Market Outlook Nov 2011

The current market environment is characterised with extreme daily volatility, and political news flow that makes investment decisions particularly testing. Just the last few days have seen the resignation of two European prime ministers, spreads of Italian debt over German bunds at an all-time high, and with tangible signs that Greek contagion is now reaching French and Spanish debt, with spreads rising. Tellingly, S&P mistakenly downgraded French debt from its AAA status before retracting the announcement- a Freudian slip? European politicians are now openly talking about a break-up of the Euro in its current form, and the UK Treasury is scenario planning for the 'financial Armageddon' of such an event. Sentiment rather than fundamentals are currently driving markets, and investors can take nothing for granted at the moment. Looking beyond this, the concern is that the uncertainty is starting to manifest itself in worsening economic data. Companies are delaying corporate investment decisions, and the US housing market is showing signs of deterioration again, with HSBC reporting an increase in mortgage arrears not only in the US, but also parts of the emerging markets indicating that no economic area has been left unaffected.

Given that government resources are already stretched, and monetary policy tools are now proving themselves relatively ineffective, it is our central case that economic growth in the West will remain anaemic.

Caution therefore continues to be warranted, but the conundrum for investors is how to allocate resources in this low growth, risk averse environment. The return on cash is minimal, thus AAA Government bonds and US treasuries remain the default safe havens despite their negative real yield. However, the governments backing them are not without their own issues which may yet come under the capital market's spotlight.

It is our belief that despite the risks, good quality equities remain an attractive asset class for the long term investor; the recent volatility presents an attractive entry point into soundly managed companies, with strong balance sheets and dividend yields that reward investors for patience. In addition, the sell-off has been indiscriminating, allowing investors to add to holdings in regions of the world that are well placed to manage low global growth.

Global Equities

+ Yields on large-cap stocks look attractive relative to fixed interest.
+ Companies with exposure to Asian and Emerging market economies have an opportunity for top line growth.
+ Many companies have strong balance sheets and are efficiently managed.
+ Companies are continuing share buyback programmes.
+ Companies are looking to secure revenue growth and cost synergies through M&A, so bid interest may drive potential targets higher.
+ Equities seem well supported at current levels
+ Global economic recovery is relatively fragile
+ Investor nervousness remains high
+ Effects of austerity packages have yet to be fully felt, and the synchronised nature of them in the UK, Euro and now the US could exacerbate the impact.
+ Tight monetary policy in the East may dampen export led growth
+ Increased international concern about currency wars and protectionism could be very damaging to investor sentiment.
+ Sovereign debt concerns may yet trigger sustained correction.

Global Bonds

+ Poor returns on cash and risk aversion are providing support to Government bonds
+ Spread of many corporate bonds over government stocks still provides scope for gain, or will protect capital values if government bonds yields rise
+ Interest rate differentials provide scope for currency-related gains.
+ Interest rates are unlikely to rise in the West for some time, and have peaked in the emerging markets.

- Valuations of many developed market government bonds look stretched given poor fiscal state of many nations.
- Inflation means that returns on AAA bonds are negative
- Interest rates are unlikely to fall further in the West, and continue to rise in the East.

UK Equities
The debate now concerns which part of the market will outperform- defensive large cap, or growth oriented export led mid cap. We believe that it is best to remain focussed on companies with strong balance sheets and visible earnings streams that are not sensitive to the UK consumer, and where margins are less affected by input prices.

US Equities
US economic recovery remains very muted, with jobs being created albeit at a very modest rate. The US housing market is still showing no real sign of recovery. Investor focus is now on the US deficit, which will be negative for the Dollar, which is good news for US exporters, less so for Sterling investors.

European Equities
Debt fears continue to dominate, with the Greek problem having been overtaken by Italy and indeed the viability of the Euro being called into question. On the positive side the German economy remains highly competitive, and equity valuations are very low. Additionally, Europe remains home to some well-regarded brands, hence giving rise to the possibility of M&A interest.

Emerging Market Equities
Growth levels and outlook remain relatively attractive, and recent index falls make valuations more interesting. Investors should be wary of bubbles developing. Economic policy tightening increases risk of policy error, and despite the beginnings of a shift to internal consumption, many markets remain correlated to Western growth. Overall, whilst we believe that the case for a shift towards these markets as the drivers of global growth remains intact, investors should be more selective in their allocation.

Asia Pacific
The region continues to enjoy robust economic growth, meaning a better corporate outlook and strengthening currencies. Despite slowing, growth remains strong compared to the West, but indices have underperformed over concerns over slowing growth rates.

Japan
The economic impact of the earthquake is still being felt. Some scope for rebuilding related gains, and valuations look attractive, but long term demographic and debt concerns remain. Recent weakness provides an attractive entry point, and volatility of Japanese stocks is relatively low.

Fixed Interest
Valuations in many global Government bonds look over-extended, and investors should position carefully to avoid capital loss. Inflation remains a concern in the medium term, but the changeable landscape makes strategic bonds look attractive. In the meantime, yields (and arguably creditworthiness) of corporate bonds and growth market debt globally remain attractive relative to Treasuries.

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