



AAG

Market Bulletin

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This weekly Briefing Note aims to pick out some of the key financial and economic issues touched on in the press over recent days, and from time to time includes the views of some of our independent fund managers.

Those Green Shoots

Maybe, just maybe, those much derided 'green shoots' of recovery, first mooted back at the beginning of the year by UK government ministers, might have taken root. Whilst still in its nascent stage, belief in a global economic recovery is growing – well, certainly if you listen to policymakers and even the cynics are having to acknowledge that we are no longer looking into the abyss. In the US, President Obama spoke of seeing "signs of economic progress" in the economic outlook for the first time since the current downturn began. Mr. Obama said, "There is no doubt that times are still tough. By no means are we out of the woods just yet ... but from where we stand, for the very first time, we are beginning to see glimmers of hope". He was supported by chairman of the US Federal Reserve Ben Bernanke, who said he was witnessing "tentative signs that the sharp decline in economic activity may be slowing". The Fed chairman based his assessment of the economy on recent positive data from the housing and other markets but stressed that this is still the worst financial crisis since the Depression.

As **The Daily Telegraph** explains, the data supporting the optimism revolves around the deeply troubled US housing market, which has been at the epicentre of the crisis, and has been in freefall for almost two years. There was more positive data in February and March – home construction rose by 22% in February and the number of people applying for mortgages rose too, spurred on by record low interest rates. Sales of new homes rose for the first time in seven months and consumer spending has risen. But as ever, the picture remains cloudy – hard on the heels of President Obama's speech came news that retail sales had gone into reverse last month, falling 1.1% - consumer spending is crucial to the US economy as it accounts for two-thirds of GDP. Alongside this headline, producer prices also fell – mainly in the energy and food sectors – due to weakening demand.

Here in the UK there was a similar message from our own policymakers with the Chancellor, Alistair Darling, due to forecast in this week's Budget that the recession

should end this year with the economy returning to growth in 2010. The new incoming member of the Bank of England's Monetary Policy Committee (MPC) David Miles also raised hopes of an early recovery. Speaking to the **Western Mail** newspaper, Professor Miles – who is the chief UK economist for Morgan Stanley – said there were reasons to be guardedly optimistic about the direction of the UK economy. "If you look at the Government's announcement on fiscal policy, the bringing forward of next year's spending to this year and the cut in VAT have only begun to have an impact within the last few months. Substantial cuts in interest rates and more quantitative easing is likely, with a certain time lag, to have a substantial impact on demand in the economy and it may well be that the worst of the recession is behind us". In our own housing market, there were signs that, despite news of some 900,000 homeowners facing negative equity as a result of falling prices, things may be improving. The Halifax announced that it is resurrecting the practice of offering large incentives to entice mortgage customers – the first time since the credit crunch hit two years ago.

With the world's emerging economies also struggling, news that Chinese manufacturers reported orders recovering from the winter's plunge added to the overall positive sentiment last week. China is expected to continue to grow but at a slower rate this year so any signs of a pick-up in activity are being closely monitored. Mervyn Davies, the British trade and investment minister, used a speech in Hong Kong last week to say that a weaker pound would increase Britain's competitiveness, boosting exports and putting us in a strong position when demands start to improve. "If you're an exporter this is a great time because of the state of the pound. There is global demand" he said and added that there was already evidence that order books at UK companies were picking up.

Risk Appetite Grows

Against an increasingly positive backdrop it is unsurprising that investor sentiment has been steadily improving since the low point back at the beginning of March when many of the developed global equity markets plumbed new lows. Last week, good news on the earnings front from several leading banks gave the markets another boost enabling leading indices to record their sixth successive week of rises. Stocks were helped by better-than-expected results from Goldman Sachs and JP Morgan in the US, while here in the UK, Barclays was in the limelight following its deal to offload its iShares unit last week. But it has not just been Financials that have done well - Technology stocks have been among the best performers in the rally of recent weeks

with the Nasdaq index up almost 30% since the March low. Elsewhere, investment grade corporate bonds continued to strike a better tone as measured by the cost of protecting debt against default in the credit default swap markets. Expectations are for an improvement in the corporate debt markets, according to analysts at SG CIB who said, "With the earnings season from the banking sector off to a good start ... there is enough to suggest we are in the early stages of the bottoming-out process". So by the end of the week equity markets had advanced once more, enabling the FTSE100 to consolidate its position above the 4,000 level.

It's Different This Time

The events of the last eighteen months have resulted in somewhat of a dichotomy – traditionalists say financial crises are nothing new and normal business will be resumed in due course. The other school of thought says we are witnessing a new order and relying on past experience is no solution, but the truth is that no one knows exactly how current events will shape the future. For professional investors, current times are indeed testing but for the likes of Richard Oldfield, a veteran investor with over thirty years experience, strategies still need to be implemented. "The last eighteen months have been the most difficult I have ever experienced and it is true to say that things are different this time. Government is wielding a large stick in companies it controls and via public spending. Policymakers globally are pursuing short-term expansionary policies, which they know to be ultimately inflationary, on an unprecedented scale. At some point these policies will need to be reined-in. Economies do change of course and today we are witnessing a significant change with all its ramifications.

"But one thing is certain: recent events have not changed the way I pick stocks – I have maintained my approach and style which seeks to identify companies whose share prices are undervalued and where, over the longer-term, they are likely to outperform. There are two main criteria I apply. Firstly, a company needs to have a strong balance sheet with net cash and which is therefore strongly financed. Secondly, the company must have products and services which will be in demand in the future – irrespective of current events. So a good test now is to ask whether the current downturn is going to imperil a company's existing franchise or not. One of the stocks I own is Fanuc which is a Japanese company and a leader in robotics – its financial strength is such that were it to earn no revenue and still meet all its spendables such as wages it could survive two years, which is extraordinary. This is the type of business I like to own.

The portfolio I manage for St. James's Place has only ten stocks so is very focused and means I can get to know the business intimately and concentrate on my

very best ideas. Microsoft remains a world-class business with huge free cash flow enabling it to develop future products, return cash to its shareholders and yet trades on only ten times earnings. Vivendi is a media conglomerate on a similar p/e, yields 5% and trades at a discount to the sum of its total parts. The US house building sector has been hit hard but I own DR Horton which currently sells below its book value but also where the longer term prospects remain positive – population growth in the US is 1%pa and housing formation is 1.5%pa so demand is there, notwithstanding events today. I own commodity and energy-related stocks such as BHP Billiton, Barrick Gold and Conocophillips: all fulfil my criteria.

No one knows whether we have seen the lows in the stock markets but I am optimistic looking ahead – in the US stocks have delivered real [inflation-adjusted] returns of 6.2% over the long term and I am a great believer in reversion to mean. But the key is to be patient and not to try market timing as a strategy – some data from the US illustrates this point well. Over rolling ten-year periods the S&P500 index has returned, annualised, 10%; the average US mutual fund 8% (which is worrying) but the average private investor portfolio only 4%. The latter is a result of people switching in and out of stocks and markets because they've experienced some price falls: staying invested is actually the best strategy. So today the portfolio is positioned for recovery - all that remains is to be patient".

Taxing Times

With the Budget on the horizon the press speculated about what actions Alistair Darling might take to help hard pressed savers who have seen their returns from cash plummet in recent months. But not many are holding their breath. "The backdrop to this Budget is one of the bleakest in living memory" according to Peter Spencer, chief economic adviser to the respected Ernst & Young ITEM Club. **The Financial Times** took the view that the government is so strapped for cash that there is little chance of any giveaways, although there have been noises that the existing ISA limit might be raised to £10,000 which would help savers. Individual Savings Accounts are free of CGT and higher rates of income tax. **The Daily Telegraph** pointed out that many investors wanting to boost their incomes had chosen to invest in corporate bonds via an ISA as part of their strategy. Corporate bond markets have been through difficult times because of the credit crunch but the environment is improving and the paper said that the BoE's programme of quantitative easing should help as the Bank buys up bonds in order to inject cash liquidity into the system. In the meantime, though, all eyes will no doubt be on Mr. Darling.

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