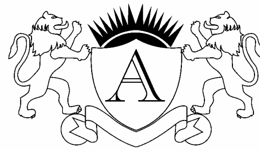

AAG

Market Bulletin

MONDAY 11 MAY 2009

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.

Markets Bedazzle

A little over two months ago markets succumbed to a wave of despondency as investors took fright at the economic outlook – economists had by this time dubbed the global slowdown as *The Great Recession* – and thrown in the towel, causing stock markets to plumb lows not seen for many years. Since then both the economic outlook and investor optimism have improved dramatically. Initially, hopes that the worst might be over were tentative, but with the ensuing flow of economic data gradually improving, confidence has grown markedly. Since the lows of early March the FTSE World Index has climbed 37% - Europe, Japan and the US markets have all enjoyed large rises and London caught up last week with the leading FTSE100 index finally regaining the level at which it ended last year. As **The Financial Times** commented, even after two months of steady gains there were few signs of investor fatigue as the market ended the week with a flourish by adding another two hundred points to leave it at 4,462. Traders commented that the overriding sense was the fear of being left behind with Tony Betts of CMC Markets saying "You could say there was an element of panic – there were a lot of underweight players driving the market higher".

So what lies behind the change in sentiment? Well, the more confident attitude has largely been built around mounting evidence that the worst of the world's economic contraction is over and a belief that the banking sector, after its near-death experience last year, is on the mend. Last week the US Federal Reserve released the much-awaited results of its '*stress tests*', an exercise carried out to assess the ability of 19 banks that received government aid to withstand a worsening economy. With the results carefully leaked in the run-up, the outcome was that these US banks needed around $75bn of new capital to bolster their balance sheets, with Citigroup and Bank of America having the largest shortfalls. Rather than frightening the markets, the news came as a relief, leading to a surge in share prices and following the revelations, US banks moved swiftly to plug the hole – Morgan Stanley and Wells Fargo raised $11.5bn in a day. Against this backdrop share price volatility retreated, with the Vix Index – Wall Street's so-called *fear gauge* – falling to around 35, down some 10% on the week and well below the reading of 89 registered in the midst of the crisis last September. So by the end of the week the world's stock markets clocked up gains of anything between 5% and 12% - the latter being achieved by Hong Kong, reflecting investors' views that the recovery will be led by emerging economies in the Far East.

Recovery Prospects Strengthen

As for evidence of global economic recovery – or at least signs that the rate of contraction has come to a halt - there was no shortage of data. India's manufacturing sector grew in April for the first time in five months, spurring hopes of an end to falling growth estimates and contracting exports. In China, the purchasing managers' index for manufacturing rose to 50.1 last month (any reading above 50 indicates growth) up from 44.8, signalling the first expansion for nine months. "China's government has been extremely successful in stimulating investment" was the view of economist Eric Fisher at CLSA, the Hong Kong-based brokerage. Beijing has strong-armed banks into extending Rmb 4560bn (£444bn) in loans in the first three months of the year – more than all new bank lending in 2008 – which has backed state infrastructure spending. However, a sustainable recovery will still require private investment and consumption according to *Dragonomics Consultancy*. In Europe, Germany's rapid economic contraction is coming to an end, according to official data – after plunging last year, industrial production remained flat in March and exports rose 0.7%, the first increase since September.

Over in the US, Fed chairman Ben Bernanke predicted that the recession would be over by the end of the year if there was not another large setback for the economy. Whilst unemployment is still rising in America – another 491,000 workers lost their jobs last month, taking the unemployment rate to 8.9% - the latest data suggests the freefall is slowing. Economists pointed to the fact that the April figures were an improvement on March when a revised figure showed 708,000 jobs lost. "By any measure except the past few months, a 491,000 drop in private payrolls is disastrous but at least it is less disastrous than before" said Ian Shepherdson, chief US economist at High Frequency Economics. More positively, the all-important US housing market appears to throwing off some of its torpor – national sales of existing and new homes rose by 5.1% and 4.7% respectively in February while housing starts and permits were also up. House prices though continue to fall according to the S&P Case-Shiller index, which has recorded falling prices for 30 consecutive months. And Americans have made a return – albeit muted

– to the shopping malls where signs of increased consumer spending are evident. Retailing giant Wal-Mart has noted a shift in spending patterns, with its US head of stores Eduardo Castro-Wright saying "People are using that money [from lower payroll taxes] to buy some of the discretionary items that they were not buying before".

V-shaped Recovery for UK

According to **The Daily Telegraph,** the Bank of England (BoE) will this week declare that it expects Britain to enjoy a powerful v-shaped recovery as it raises its inflation forecast for the first time since the onset of the crisis. The paper said that the Bank is likely to use its key quarterly *Inflation Report* to raise its projection for the CPI over the next two years. This indicates that the BoE no longer sees deflation as a threat, but there are no signs that the Bank will rein-in its policy of quantitative easing (QE) – it has been spending tens of billions buying up gilts and corporate bonds as a way of increasing money supply and bringing down gilt yields. QE is seen as ultimately inflationary – a point made by economist Liam Halligan who took the view that the policy had failed and, once ended, left a big question mark over who would buy the £200bn of new gilts to be issued over the next few years. Gilt yields, according to data from Reuters, are actually at a higher level now than before the new policy was implemented back on 5 March. In the meantime the BoE has announced it will spend a further £75bn on top of the £50bn already spent.

Away from the markets the real economy, like its foreign counterparts, is showing signs of life. Last week, the sharpest improvement in conditions in Britain's service industries for a decade combined with signs of revival on the high street boosted hopes that the worst of the recession is over. The view was supported by comments from the CEO of fashion chain Next, Simon Wolfson, who said "Things have potentially bottomed out . . . (the downturn) is not as bad as we thought it was going to be". In what was seen as one of the most promising green shoots of emerging recovery yet the key CIPS purchasing managers' index of services activity leapt from 45.5 in March to 48.7 last month – its fifth consecutive gain. Alongside this, a survey of consumer confidence by the Nationwide detected the steepest rise in sentiment for two years in April, with its index hitting 50. And our own housing market looks to be improving too despite prices continuing to fall – down 1.7% in April according to the Halifax – but at a slower rate. Interest amongst buyers is on the up according to the Royal Institution of Chartered Surveyors whose own index of future buying intention rose to plus 31 – up for the fifth consecutive month. Comments from the UK's largest lender Lloyds Bank, which has a 30% share of the mortgage market, also support a more positive outlook. The bank reckons that house prices will fall less this year than it previously thought – down 10% as opposed to 15% - with prices bottoming within months and signs of price increases by the end of the year.

A Professional View

John Innes of RWC manages UK equities for St. James's Place and he gave us an insight into recent events and what it means for his portfolio. "After a disappointing start to 2009 and with the equity market so oversold, any signs of optimism were enough to start a rally led by the Miners, Basic Materials and Financial sectors where appetite for cyclicality increased. In the UK, investors chose to focus on the likely impact of the Quantitative Easing programme which followed the reduction in UK interest rates to historic lows. Furthermore, in the US the announcement by several banks of a good financial start to the year helped the market recover a bit of ground. The portfolio was a beneficiary of the cyclical bias to performance in the month with some very strong returns at the individual stock level. For example Anglo American, Xtrata, Cookson, Lloyds Bank, Prudential all posted strong double digit gains from very oversold levels. The smaller companies were also more stable and with many trading at extremely low valuations - Spark Ventures, Macau Property, Findel are good examples - there remains considerable potential for gains from these stocks as they demonstrate their robustness and exceed earnings/asset value expectations.

Having pre-positioned the portfolio I have made few changes in recent weeks. The holding in Capita is being reduced post a period of strong performance as the valuation is looking stretched and recent Director selling has provided further encouragement to sell. The proceeds of the sale have been reinvested in Debenhams which is trading at a material discount to the market and the sector, has an extremely high 'short' interest and where EPS [earnings per share] momentum is turning positive due to solid execution in a UK retail market showing tentative signs of stabilisation. So for now I am maintaining my strategy for growth and believe the portfolio is well-positioned for recovery".

Green Light?

The events of recent weeks led **The Times** to mull over whether, as the stock market recovery gathers pace, this is the green light for investors to buy back into equities. The paper said that cash levels held by professional investors in their funds are a useful indicator and liquidity levels dropped last month to 4.9%, according to investment bank Merrill Lynch, yet still remain high by historic standards, indicating there are plenty more funds available to fuel the rally. The Bank also pointed to the fact that for every sale there are four company directors buying, which historically has been a good lead indicator. Some stock market analysts have been even more forthright in their views. David Schwartz, a prominent stock market historian, said the lessons from the past century of share price ups and downs pointed decisively to a new bull market. "History says fill your boots, sell your wife, dive in" he told **The Times** which perhaps could be the least politically correct headline of the recession!

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