Investment Bulletin

SAUNDERSON HOUSE

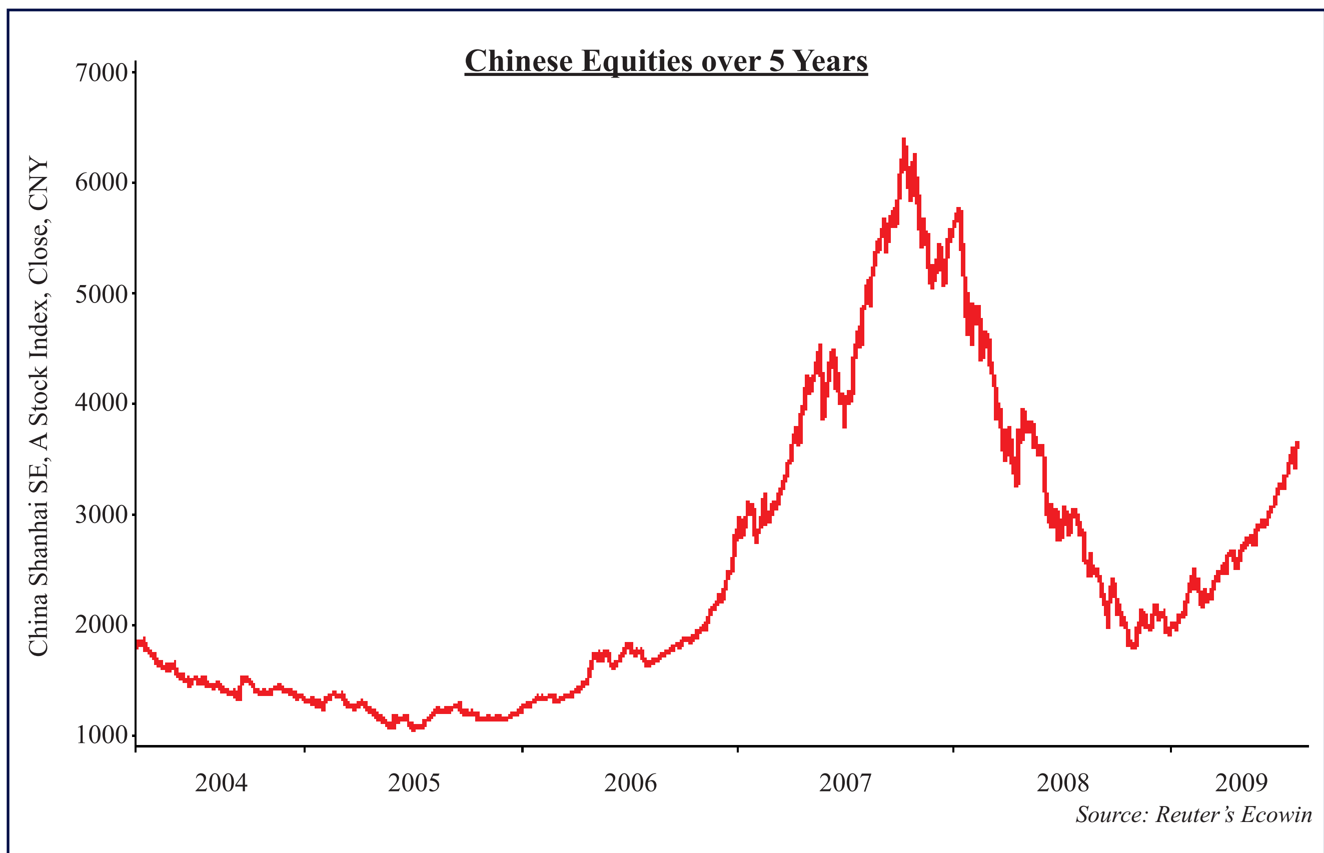
14 August 2009

FOCUSED FINANCIAL ADVICE

OUT OF INTENSIVE CARE

Evidence is mounting that the worst of the recession is behind us. Most economic data releases show a degree of recovery from the dark days of winter, and many companies have announced earnings which have beaten (much reduced) expectations. Stability is returning in areas such as retail sales and house prices, albeit at levels well below those achieved before the credit crisis. We are pleased to report that the 'patient' is heading out of intensive care.

While much of the financial landscape has changed dramatically over the past twelve months, some aspects are disturbingly similar; for example, equity prices are rising once more and appetite for risk assets, such as emerging markets equities and commodities, has returned with remarkable speed. As the chart below shows, Chinese equities are climbing their way back towards the heady levels reached in 2007.



As we mentioned in our last note, 'Keeping your Balance', some recovery in equity prices appears justified given that it appears an economic slump of the magnitude of the 1930s looks to have been avoided. However, in our view, the world economy is set for a subdued recovery at best. The resurgence in risk appetite and the sharp bounce in emerging markets equities, therefore, seem somewhat premature. While we are pleased to see the patient leaving intensive care, we are a little disconcerted to see marathon training resume so quickly.

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We are focusing on China because so much of the good economic news has emanated from there. Outstanding second quarter growth figures (7.9%) have reassured investors that the world is not bereft of economic growth, while Chinese stockpiling has started moving commodity prices higher once more and chased away concerns about deflation. However, closer inspection reveals a number of concerns. For example, China's $585bn fiscal stimulus is aimed primarily at increasing investment in infrastructure. This boost is being funded by the banks which, in the first six months of 2009, expanded lending at three times the pace of last year. As a result of the stimulus, investment spending accounted for a surprising 88% of the economic growth China achieved in the first half of 2009. Allied to this are concerns that, in a centrally controlled economy, an instruction to banks to lend is not optional. There is a strong likelihood that banks have lent with little regard to whether such loans will be profitable. We are, therefore, concerned that China's growth is likely to be of dubious quality.

Beyond these concerns is the simple fact that Chinese equity valuations are already once more in dangerous territory. They trade on a price to earnings ratio of c35x compared to the UK's FTSE All-Share price to earnings ratio of 14x. In terms of price to book value, they have soared from below 1.5x in the fourth quarter of 2008 to 2.3x, a significant premium to developed markets such as the US and Europe. Our suspicion is that China's fiscal expansion is sowing the seeds of a financial crisis comparable to that just experienced in Western countries.

Our recommended portfolios are currently benefiting from (i) the broad advance of equity markets in attractively valued developed markets (which do, of course, provide indirect exposure to emerging markets through companies' operations in these economies), and (ii) the revaluation of corporate bonds now underway. We are keeping a very close watch on commercial property, where value is likely to become apparent in the next few months.

Our view is that the worst of the credit crisis is behind us and that global economies can make a gentle recovery. However, we are wary of any expectation of a quick return to a pre-crisis financial landscape; the process of repair will be a long one. Furthermore, we are concerned that the current investor enthusiasm for emerging markets equities and commodities is inflating a bubble not dissimilar to that which burst in 2008. Our challenge, therefore, as investment advisers, is to resist the temptation to chase price momentum and, by remaining firmly rooted in the principles of "value investing", avoid being left holding the bubble.

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