Investment Bulletin

SAUNDERSON HOUSE

18 December 2009

CONFLICT-FREE FINANCIAL ADVICE

TOWARDS 2010 - EXCHANGING BUNGEE JUMPING FOR TIGHTROPE WALKING

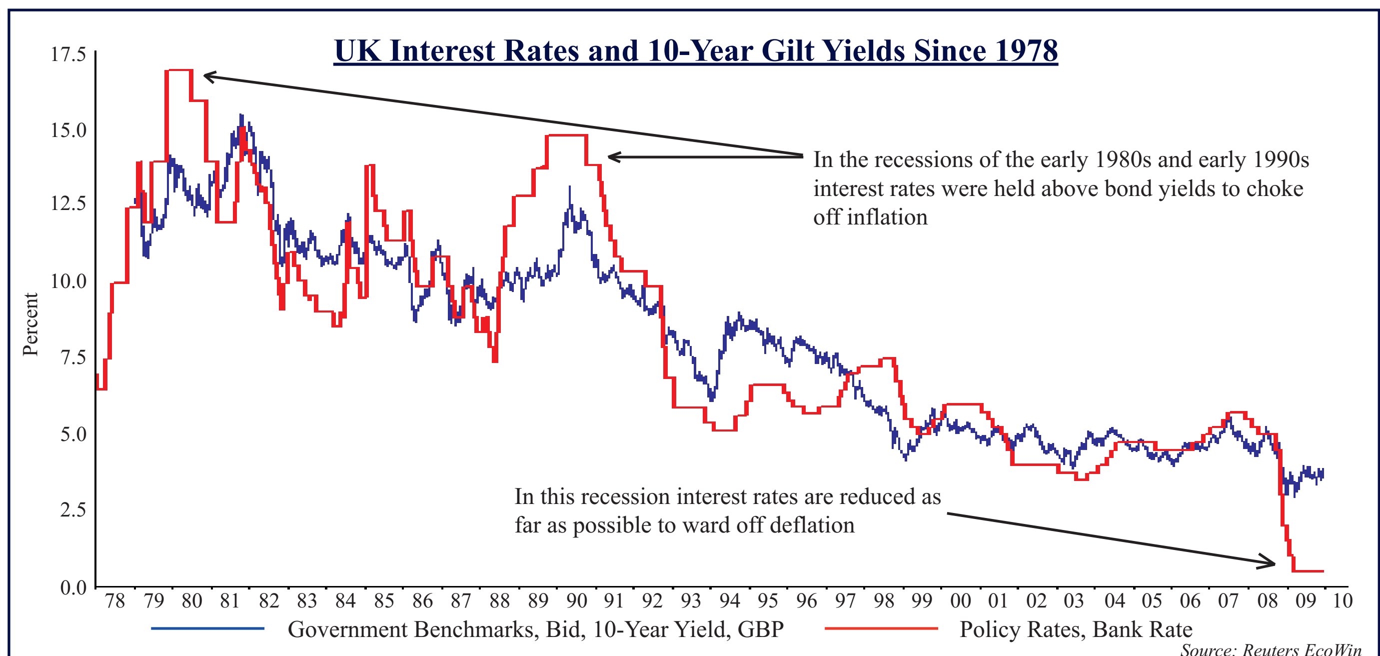
(LATEST NEWS: Anthony Bolton and Angus Tulloch, brought together by Saunderson House, to debate China and Emerging Markets on 25th January - see below for details.)

Holders of equities through the last eighteen months have been subjected to an experience not unlike a bungee jump. The MSCI World Index fell by 60% from its late 2007 peak of 428 to a low of 173 in early 2009. From March, share prices have rallied strongly, with the MSCI World Index recovering to 295. Though this represents a 70% rally, shares are still significantly below the 2007 high.

As 2009 draws to a close, investors must now consider the challenges of 2010. As advisers, a big question for us is: why is there such an enormous divergence of opinion among economists, investors and market commentators regarding the future path of the global economy? Many expect a repeat of the 1930s, with disappointing economic growth, rising unemployment and, possibly, deflation. Others see an almost opposite outcome, more like that of the 1970s, with inflation surging and governments struggling to control public sector debt.

Our view is that we are likely to see a weak global recovery with little upward pressure on consumer prices. Thanks to government intervention, however, a re-run of the Great Depression now looks unlikely, though this has come at the cost of high public sector debt that will necessitate tax rises in many major economies. While low growth and low inflation is, in our view, the most likely outcome for 2010, we will of course continue to recommend diversified portfolios, including inflation hedges such as index-linked gilts, to guard against the unexpected.

The chart below illustrates, for the UK, why we believe low growth with low inflation is the most likely path for the economy in 2010. With interest rates being held at very low levels internationally, the picture is broadly the same in other developed markets. The chart shows that in both the late 1970s and late 1980s, UK interest rates were raised above the 10-year government bond yield (this is, in effect, the 10-year interest rate) to halt spiralling inflation expectations. High interest rates drove the economy into recession by making it very expensive for consumers and businesses to borrow. When the inflation threat had passed, interest rates came tumbling down and pent-up consumer demand was unleashed, delivering a strong economic recovery.



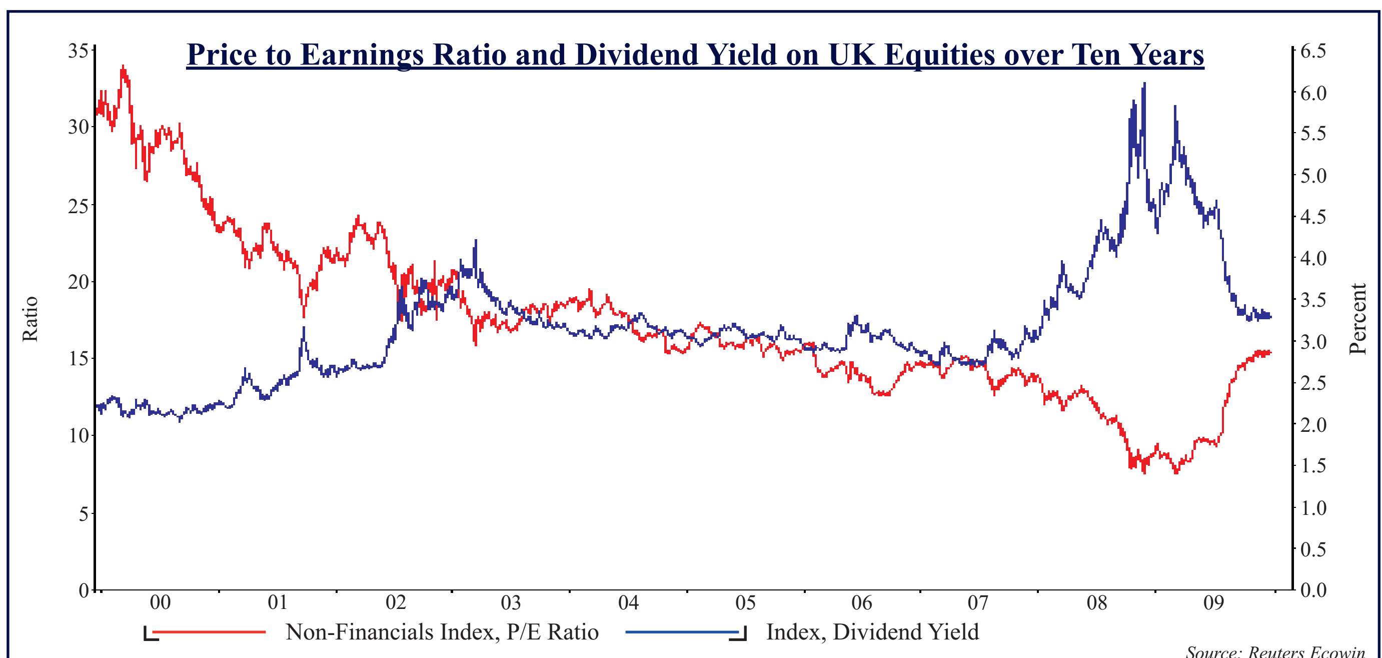
This recession has been quite different from the earlier ones. As is apparent from the chart, the Bank rate has been reduced as far as practically possible, and is significantly below the 10-year gilt yield. The Bank of England has delivered interest rate cuts of this magnitude in an attempt to support consumers and companies. This time there is no pent-up demand; quite the opposite in fact. Consumers would rather reduce spending, pay down debt and rebuild their balance sheets. The Bank of England is trying to discourage them from doing this too quickly, for fear of prolonging the downturn.

Why do we believe a nasty inflation shock, caused by all of this newly 'printed' money, is less likely than the low growth, low inflation scenario set out above? The inflationary outcome is certainly a popular view at present, and one that is appealing on first inspection. After all, wouldn't governments and consumers love to see the real value of their debt eroded by a bout of high inflation? Well, yes, of course, but for governments and consumers to gain from inflation someone must lose. Those losers would be savers and investors, whose purchasing power would be eaten away by inflation.

We believe that, long before inflation became a serious issue, investors would have sold their government bond holdings and would be refusing to buy the new issues so vital to balance the public sector's books. In the UK, we saw a hint of this last week. Alistair Darling's pre-budget report did not reassure investors on the strength of government finances and, as a result, government bond prices fell sharply. Any loss of confidence in government bonds would see the cost of financing public sector deficits spiral and might well plunge the economy back into financial crisis, killing off any economic recovery at a stroke. Governments and central banks around the world are, of course, painfully aware of this. So, while they would quite like a dose of inflation for Christmas, it seems unlikely that bond markets will allow it.

Bond markets will, in effect, force governments to walk the tightrope. The authorities must direct policy as best they can to ensure that the economy does not lapse back into recession while maintaining credibility with the holders of government bonds. Staying on the tightrope will, in our view, result in the lacklustre recovery mentioned above. Interest rates will remain low to allow for tax rises. Staying on the tightrope will also mean the rapid removal of monetary stimulus should economies look like sliding towards the inflationary outcome.

What does all this mean for investors? A subdued recovery, with low interest rates should, we believe, provide a reasonably positive backdrop for equity markets. Our case is supported by undemanding valuations. For example, the chart below shows the price to earnings ratio and dividend yield for the UK's FTSE All-Share Index.



The price to earnings ratio is, despite the rally in share prices since March, low relative to recent history. Providing earnings are not undermined by a renewed downturn in the economy (such weakness in the economy would indicate, perhaps, that we haven't escaped a re-run of the 1930s), valuations appear reasonable. The dividend yield, despite falling sharply from the heady heights of late 2008 (due to dividend cuts as well as the rise in the market), again, looks reasonable relative to recent history. The very low level of interest rates means that the yield on equities is also attractive relative to the return on low risk investments, such as cash deposits.

In respect of other assets, despite the strong performance during 2009, we continue to favour corporate bonds. Yields remain attractive when compared to both gilts and cash deposits and, as long as the worst of the recession is behind us, we should see a gradual improvement in company finances. Finally, regular readers of our Financial Markets and Portfolio Updates will know that we are now favouring higher allocations to prime commercial property both to collect the rental income and, on a five-year view, to benefit from a hoped-for recovery in capital values from the steep falls of the past two years.

The net result of the changes to asset allocations this year is that portfolios now have higher allocations to risk assets. This, we believe, is appropriate given the value on offer and the low yields available on government bonds and cash deposits. Through 2010, as ever, we will be seeking to continue our own balancing act, ensuring that recommended portfolios achieve good returns while taking every precaution to minimise risk.

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We are delighted to bring together our good friends, Anthony Bolton of Fidelity and Angus Tulloch of First State Investments, to debate China and Emerging Markets. Anthony has enjoyed enormous success as a fund manager in the UK and Europe for three decades, and has recently announced the launch of a Chinese equity fund, a new venture for him. It will be fascinating to hear his views together with those of highly experienced and successful Asian and Emerging Markets investor Angus Tulloch, whose firm currently manages c$30bn in the region.

The seminar will be held at 12 noon on 25 January at Plaisterers' Hall, EC1A 4HR. If you would like to attend do please reply to china.seminar@saunderson-house.co.uk.

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This note is for general guidance only and represents our current understanding of law and HM Revenue and Customs practice as at 18 December 2009. We cannot assume legal liability for any errors or omissions and detailed advice should be taken before entering into any transaction. The value of investments and any income therefrom can go down as well as up and you may not get back the full amount you invested. Levels and bases of, and reliefs from, taxation are those currently applying but are subject to change and their value depends on the individual circumstances of the investor. Saunderson House Limited is authorised and regulated by the Financial Services Authority.

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