Investment Bulletin

SAUNDERSON HOUSE

20 MAY 2011

CONFLICT-FREE FINANCIAL ADVICE

STAY IN MAY...

...and never mind about St Ledger's Day! The old stock market adage to sell in May and go away until September has generated the usual press comment as we move towards the quiet summer months. Instead of relying on folklore that advocates the turning over of portfolios, we believe that concentrating on long term asset allocation and cutting out unnecessary costs should prove fruitful in the quest for capital productivity.

In this note, we consider the key developments of the year to date and provide our views on the outlook for commodities, company earnings and equity markets. We conclude that the upside for commodities is capped in the short term while, despite the recent volatility, it is right to retain holdings of equities.

* * * * * **LATEST NEWS** * * * * *

Bob Geldof KBE, Chairman of 8 Miles LLP is to join Saunderson House to discuss investing in Africa on 4th July – see below for details and p11 of yesterday's FT (19th May) for a timely article on the subject.

The year thus far has been highly eventful. For investors, the major issues have been soaring commodity prices, rising inflation, the resumption of the eurozone's fiscal crisis and the prospect of a rating downgrade on US government debt. These developments have of course followed hot on the heels of political upheaval in North Africa and the Middle East, and the Tohoku earthquake off the coast of Japan, all of which have affected sentiment towards energy prices.

Beneath the headlines, the economic news flow has been volatile but broadly consistent with our roadmap of an ongoing global economic recovery, albeit one that is inflation-prone, patchy and anaemic. Despite the stuttering nature of the recovery, there is growing evidence of its durability, as demonstrated by strong outlook surveys and the IMF's upgrades to its forecast for economic growth. Indeed, such is the confidence of the ECB (the eurozone's central bank) in the continued improvement in Europe's economy, that in April it took the step of becoming the first major central bank to raise interest rates in the current economic cycle.

Though the ECB lifted its key interest rate by only a quarter point to 1.25%, the move is highly significant indicating that, despite the travails of Greece, Ireland and Portugal, inflation is now the chief concern of policymakers, rather than a lack of growth. Similarly, in the UK, the elevated level of inflation means that an increase in interest rates is moving closer. However, with the full effect of fiscal austerity yet to become clear, the Monetary Policy Committee of the Bank of England is "holding fire" for the present. In the United States, as seen in the minutes of the last monetary policy meeting, the language of the Federal Reserve Bank is focusing increasingly on when the withdrawal of exceptional monetary policy measures will begin.

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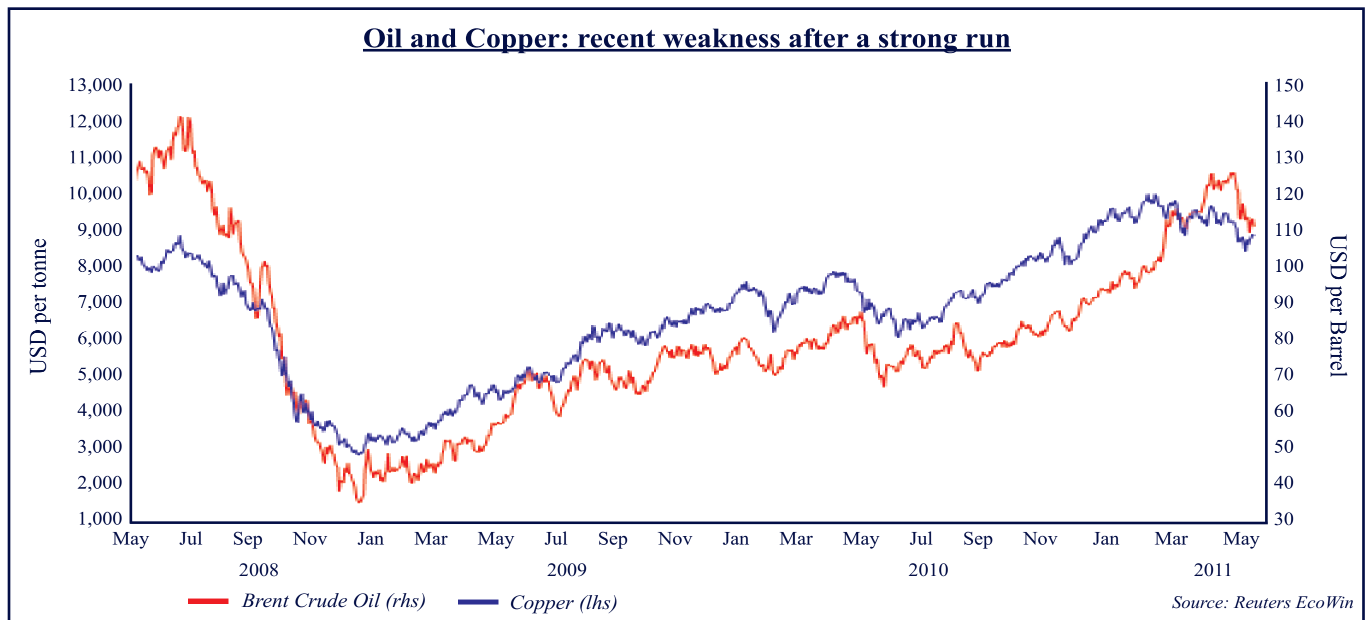
Optimism about global growth, such as that expressed by the IMF's upgrades, is apparent in the price of commodities, such as oil and copper. Until the recent setback, prices had risen in unison as confidence in the continued recovery in the developed world and strong ongoing growth in emerging economies, gathered momentum (see chart below).



While the gradual improvement in the economic outlook has underpinned higher commodity prices, the extent of the rise, particularly in oil, has caused growing concern for economists and investors; rapidly rising commodity prices give additional upward impetus to inflation and undermine consumer spending power. Thus, high commodity prices contain the seed of their own undoing; they eventually erode the demand that helped to elevate them in the first place.

We have witnessed a perfect example of the above self-correcting market mechanism in the past few weeks. As oil prices moved above $125 per barrel, concern grew about both demand destruction (people or businesses switching fuels or simply using less) and the negative impact on consumers' disposable income due to higher fuel bills. These factors combined to trigger a correction at the beginning of May, which saw oil fall by $17pb in a single week (accompanied by falls in other commodities such as silver which fell by 30%). This correction in the oil price, in turn, went some way to alleviating the concerns about the impact of high oil prices.

In our view, therefore, the global economy remains trapped between two boundaries. On the upper side, when optimism about the economic outlook becomes elevated, rising commodity prices, higher government bond yields and the prospect of interest rate increases begin to undermine confidence. On the lower boundary, when optimism wanes, lower government bond yields and lower commodity prices, together with further policy support, such as quantitative easing, put a floor under both growth and asset prices.

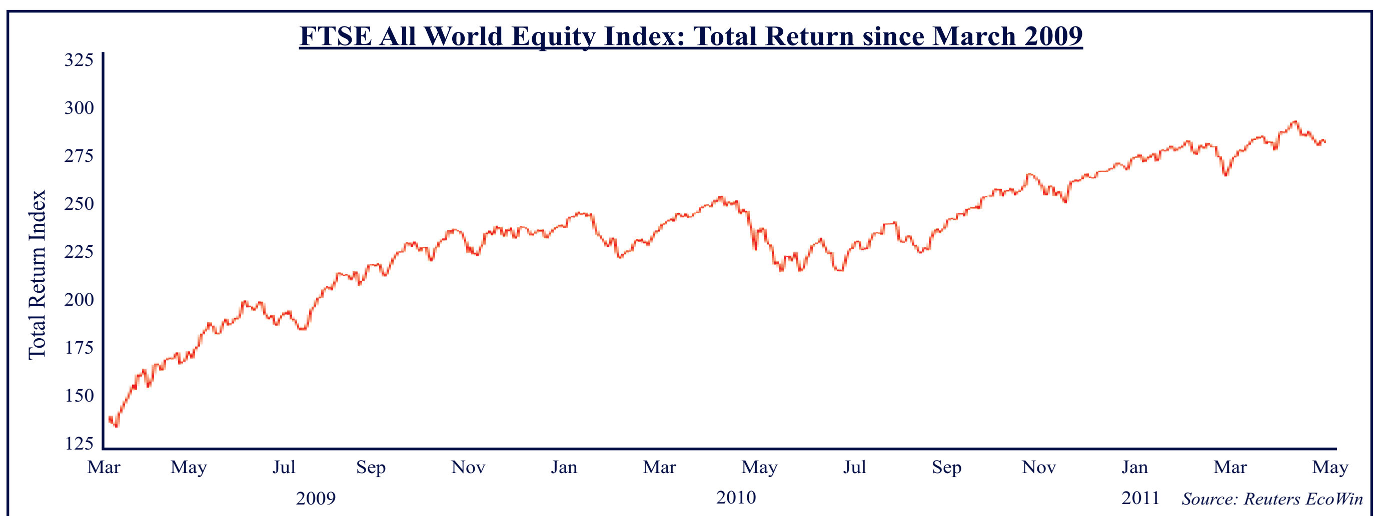
What do these developments mean for investors? In our view, there are three key conclusions:

(i) Within the constraints mentioned above, we are likely to see a continuation of the lacklustre recovery, as developed economies slowly work through their structural problems. To nurture this recovery, interest rates are likely to stay low. They will probably remain below the level of inflation for many months, meaning that real returns on cash deposits will stay negative.

(ii) While we might expect bond yields to rise gradually as the recovery proceeds, any sharp increase would undermine economic growth, which means bond yield increases will be limited. Thus, while government bond yields look unattractive, prices are unlikely to fall far.

(iii) With growth set to continue, albeit at a meagre pace, and interest rates likely to remain low for a prolonged period, the operating environment for companies will stay broadly supportive. This is helpful for equities.

A noteworthy feature of the post-crisis financial landscape has been the strength of corporate earnings. Such earnings growth has driven the rise in share prices since the market lows of early 2009 (see chart below). While the rise in share prices has been punctuated by occasional, unhelpful news flow (such as that from the eurozone, North Africa or Japan), equities have resumed their upward path after each setback. We expect this trend to persist and thus recommend that current allocations to equities are maintained.



To provide diversification in portfolios, we continue to recommend holdings of strategic bond funds, where managers have the tools to protect their portfolios from the risk that government bond prices fall and also the opportunity to profit from the benign corporate operating environment by holding non-government debt.

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On Monday 4 July 2011, we will be hosting a lunch at Plaisterers' Hall in the City where we will interview Bob Geldof KBE, Chairman of 8 Miles LLP about the attractions, opportunities and risks of investing in Africa. As yesterday's FT article 'Ripe for Reappraisal' points out, many African economies are experiencing very rapid economic growth and, with a total population of c1bn people, it is quickly rising up the agenda of global investment managers. If you would like to attend please reply to: africa.seminar@saunderson-house.co.uk.

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