

PROFESSIONALS' VIEW – AUGUST 2010

Getting Stressy:

This time last month we were saying that the stress-testing of European banks was a light at the end of a tunnel – we just weren't sure whether it was daylight or an onrushing train. This month, having been tested with the astoundingly high success rate of only 7 failures out of 91 that were examined, we're still not sure, although daylight holds the immediate upper hand as evidenced by soaring bank prices in the week immediately following the publication of the results.

Some people are treating the banks as they would a spouse who has been guilty of serial misdemeanours. They listen to the excuses but don't believe a word of it. In fact, it is very difficult to find anyone who believes the results, yet there has been an initial relief rally in the markets. Oh how we *want* it to be true. Those of a more forgiving nature point to the accompanying relaxation of what are known as “the Basel III” reform proposals for the sector (in which previously recommended capital and liquidity requirements were watered down and compliance extended to as long as eight years) as being key in allowing the banks more time and flexibility in rebuilding themselves. Jupiter's Guy de Blonay points to the markets “understanding the purpose of the exercise, which is really to improve disclosure and transparency” while AXA's Nick Hayes agrees that the “positive is definitely the more disclosure.” Henderson's Emily Anderson sees the most important element being the “longer implementation period out to 2018, which should allow many banks to increase their capital base over time through retained earnings” [*Investment Week* 02.08.10]. It is this very point though that disturbs others who see bigger dangers lurking ahead as a result.

Japan Revisited?

James Ferguson writing in *Money Week* sees the stress tests as a lost opportunity with inherent risks as a result. Comparing the American and European versions of the tests, he points out that the US were far more stringent on their requirements yet still there are hidden, and

mounting, bank losses which explains why bank lending in the US is continuing to shrink at an annualised rate of

7%. This is on the back of the US banks being forced to raise an extra \$100bn in capital by the regulators. The figure that the Europeans have ordered from their charges is just \$4.5 bn. This suggests that the hidden losses on the Continent are far greater than in the US and we are seeing bank lending shrinking as a result.

We have already heard our coalition Government calling for the banks to lend more to small businesses, but there seems to be a reluctance to do so. Repairing a balance sheet takes a long time and Ferguson suggests that there is “anecdotal evidence that British banks are refusing to carry out written valuations in order to disguise what proportion of their commercial book is in breach of covenant. In America...maturing loans that can't be refinanced or repaid are having their maturity extended instead, with no write-down by the bank required. This is the “extend and pretend” approach – living in hope that a recovery will make the problem go away.”

Japanese banks refused to admit the scale of their losses too, trying instead to trade their way through. We all know what happened to the Japanese economy as a result. The longer that it takes banks to recognise their losses, the longer it takes for them to start lending again. If the banks don't lend, the economy stagnates and we become stuck in a vicious circle of banks needing to maintain and grow capital while business cries out for it. But then, no-one said that solving the financial crisis was going to be quick or easy.

In The Meantime, Life Goes On:

Even in Japan, life did not stop. Far from it. The Japanese simply found other places in which to invest in order to maintain their income and monetary requirements. They had to look overseas for returns, which is something that UK equity income investors would be well-advised to do if they have not already

realised that the traditional equity income model is wobbling.

Those dependent upon their usual UK stalwarts of the banks and BP for their income have seen it evaporate quicker than England's World Cup dreams. To be fair, the warning signs have been there for all of those who view with suspicion anywhere beyond This Green and Pleasant Land for some time now, but BP may well be the final straw.

On the other hand, David Stevenson says that "the worm has finally turned in key markets overseas, especially in the developing world, where leading companies are beginning to boost their payouts at unprecedented rates" [*Investment Week* 02.08.10].

This is echoed by Edward Lam, (manager of the newly launched Somerset Emerging Dividend Growth Fund,) who trips out some interesting figures. He claims that "there are more mid to large cap companies in emerging markets that have paid a dividend in each of the last nine years than there are in Britain," and that "in the past 12 months mid to large cap emerging market companies paid out about \$150 billion in dividends – two-thirds of the American total and twice that of Britain." Eyebrow-raising stuff.

The reasoning behind it is plausible too. He argues that emerging market locals want stability and income as they grow wealthier, not the associated volatility with which such markets have been labelled thus far. Furthermore, emerging market companies and countries want to reform capital markets to produce less volatility and become less dependent upon external capital. We have said before in our newsletters that the whole notion of traditional risk needs to be examined, and that what were perceived to be low risk and high risk have effectively changed places. Whilst risk needs to be kept in context with each individual requirement, it does appear that those who could not contemplate the risk of investing overseas are being taught a fairly harsh lesson.

Other Rays Of Sunshine?:

There appear to be quite a few if the following comments are to be believed. Paul Causer, joint manager

of the highly successful fixed income range at Invesco Perpetual, predicts that risk assets will rally until "at least the fourth quarter." For risk assets read equities and commodities he takes a contrarian view to most of those quoted previously regarding the stress tests when he says, "people who say the stress tests were a non-event are completely wrong. The fact they did it and provided information was an event." These wildly differing views are what make investing so interesting. *Someone* is going to be more right than the other. So for those with a half-full outlook on the world, here are some more bullish soundbites from the last week or two (in no particular order of preference):

"Gold tipped to reach record highs despite dip" [*Investment Week* July 26th]

"Gold: the "off" season is a good time to buy" [*Money Week* 30th July]

"We are increasingly excited about Japan....The equity market could be absolutely remarkable in its upward parabola" [Jonathon Ruffer in *Money Week* 30th July]

"Emerging Markets still offer value" [Mark Mobius in *Investment Adviser* 2nd August]

"Findlay Park are...finding valuations (of US Equities) about as compelling as it can ever remember" [*Investment Adviser* 2nd August]

"Valuations of selected equities look particularly compelling" [Daniel Sacks of Investec Asset Management in *Investment Adviser* 2nd August]

"Equity valuations are cheap (in the US)...investors can find bargains in equity markets as valuations remain low" (Peter Hensman of BNY Mellon in *Fund Strategy* 2nd August)

So despite the caution, we can see that there is no shortage of optimism out there. Timing is of course all important to overall returns, and is probably the most random of all considerations as well as being the most difficult to achieve. It is always entirely possible that cheap equities can get cheaper still, but maybe now may not be a bad time to begin rebuilding an equity portfolio with an eye on the longer term.

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