

A Trilogy Of Nasties:

From late summer to the end of October, the world seemed at peace with itself. Investing was easy. You simply put your money into any stockmarket investment and watched your capital appreciate at a rate that did in a couple of months what two and a half years in a bank deposit account has failed to do. QEII set sail from the US and liquidity flowed freely. The concerns over European debt were those of an anxious parent. Your sullen teenager may be out late but they'd be home soon enough when they needed more cash and feeding. Same old, same old.....

Then three things happened quickly one after the other and suddenly alarm bells started ringing. The Euro-debt problem raised its head violently in the shape of Ireland insisting that it didn't need help. Like a football manager given a vote of confidence, we knew that they would end up taking it. Contagion became the buzzword. Who's next? Portugal was seen as a near certainty, but will Spain succumb? Then Italy? Belgium? Even France was mentioned. Surely the Eurozone couldn't deal with failure on such a large scale?

While this was going on, the nightmare of all neighbourly tiffs took a massive turn for the worse as North Korea shelled and killed South Koreans. For good measure, Wikileaks published an eye-opener or two suggesting that Saudi Arabia and UAE among others had asked the US to bomb one of the other Arab states, Iran. Immediately there were mumblings about oil returning to \$100 a barrel. These were seriously worrying developments. At such times it's easy to panic – perhaps we should – but a deep breath leads to a number of thoughts about the bigger picture being formed that suggest that things might just be as OK as the late Summer suggested. Here's what we're thinking.

Emerging Markets

The emerging market story is one that we have championed over many months (if not years) through this newsletter, and we're not about to change our opinion about it for the longer term. BUT.....we are becoming increasingly nervous at the wall of money that is now surging into these markets as if double digit returns were a no-brainer.

In 2008 the world was united in dealing with a common problem. This is not the case any more. *Inflation* is increasingly a worry for emerging market policy makers, whereas the resumption of QE in the States and a possibility of the same in the UK in 2011 is testimony to the main concerns in the developed world being *deflation*. The respective paths are diverging and it is not a case of one- size fits all any more. So while we are still very keen on emerging markets from an economic perspective, valuations are looking a little stretched. It's all well and good to buy a story, but not at any price. Momentum is a key driver for markets and it is easy to hop off the bandwagon far too early. This is why we are not selling out of our emerging market plays, but we are not going to add to them and we'll look to put some profit elsewhere in the hope of finding a bit more value.

Europe

This may be a surprising place to start, but we don't think that Europe (or at least core Europe) is as much of a lost cause as it is often painted. Some will think that we have lost our marbles, but hear us out. Firstly, the sovereign debt crisis will not go away any time soon, we appreciate that. It will continue to cause uncertainty and volatility. Having said this, the impact on European markets this time around with the Irish bailout has been more limited than the first crisis with Greece. In the same way that the US authorities appear to indicate that they will do anything they can to

stave off deflation, the Europeans will most likely do the same to avoid a disorderly break-up of the Euro. This is very different from saying that the Euro will survive.

The problems with the peripheral countries are masking some interesting statistics within the core, and in particular Germany. We were surprised to hear that German unemployment is lower than at any time since 1993. The worries in the US and the UK concern rising unemployment. European consumer confidence has rebounded sharply since 2007, unlike the US where it still remains low. Core Europe remains an industrial powerhouse, with industry making up a far greater proportion of GDP than in either the UK or the US. And to whom are the Europeans selling? Why, the emerging markets of course. A weakening Euro is music to the ears of exporting Europeans.

Car sales, for example, are poor within Europe itself and the US, but look further afield and sales are surging. In particular the luxury car market is booming in China, and German car manufacturers dominate this sector. It may not be too sweeping a statement to say that if the car sector does well, then the German stockmarket does well too.

What makes the European sector so interesting is that virtually no one is talking about it in anything other than troubled terms. If it is a major beneficiary of the aforementioned emerging market growth story, yet trades at a greatly discounted level than those markets themselves, it appeals to our contrarian nature.

Korea

The latest spat between the Koreans from the North with their Southern neighbours is undoubtedly an escalation of previous events, but we feel that we can take some heart from signs of impatience from China. If the Wikileaks publication is to be believed, China has referred to North Korea as a spoilt child trying to gain attention. It may well be dangerous, the more so because there is a succession issue going on at the

top, but will things really be allowed to escalate to such an extent as to destabilise the Asian region? Surely it is not in China's interest to let this happen. Let us hope that it is just sabre-rattling on the Korean peninsula, and if it is, we should see Asia continuing to drive forward. As Scott McGlashan (manager of JO Hambro Japan Select Fund) says, "If investors are bullish on Asia, it is difficult not to be positive on Japanese companies" [*Investment Adviser* 29.11.10].

Japan

For the second time in one newsletter it may appear that we have lost our marbles in being interested in a "must avoid" market like Japan. Will we never learn? Every time Japan is tipped to show signs of recovery, it disappoints. Yet here we are again, listening to the likes of McGlashan and Ruffer Investments, both of whom are extolling the growth prospects of the Japanese market.

Maybe this time, just maybe, they'll be right. We know that one month is pretty meaningless in investment parlance, but nonetheless we noticed with some interest that the Japanese market comfortably outperformed the UK, the US and yes, even the emerging markets, in the month of November. We are considering diverting some of the profits that have been made from the emerging markets into Japan, especially as the dividend yield on the Topix index is now akin to the S&P 500, something that has rarely happened in the past 30 years. Will this be enough to tempt Japanese domestic investors to buy their own market again? 2011 will reveal all.

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