

PROFESSIONALS' VIEW – MAY 2010

In March, We Said.....

“If you recall, Bear Stearns failed some three months before Lehman Brothers nearly took the rest of the financial world with it. Have we been given a similar warning to a comparable domino effect building throughout Europe? Let’s not make the same mistake as before and be caught by surprise when it comes.” [Professionals’ View March 2010].

Events are unravelling quickly throughout Europe. But it is all very well reporting on what has already happened. It is to the future that we need to look in order to protect and grow our invested capital, whether it sits in a pension fund or in an ISA. If changes are required, could this be the time to make them? If not, could any losses that have been recovered since 2008 potentially be made again?

What Of The Single Currency?

Thanos Papasavvas, Head of Investec’s currency management team sees three possible outcomes to the travails affecting the Euro at present. One is that the Southern European countries could be forced out of the single currency, which would result in a strengthening of the Euro but present serious difficulties for the ejected countries. The second is that Germany pulls out of the Euro and reinstates the Deutschmark, causing a significant weakening of the Eurozone economy and currency. Third, is that the countries in difficulty now would be put on a “three year probation” during which they will be monitored to ensure they are tackling budget deficits and reducing their debt liabilities.

Not one of these outcomes is going to happen overnight and each one equals upheaval of some kind. Maybe none will come to fruition. One thing is for sure though. If you shut your eyes and hope for the best you are taking a high-risk strategy with any money that you have invested in Europe just now.

Sell in May?

At time of writing, the UK market is 8% off its high point that it reached towards the end of April. That old adage, “sell in May and go away, don’t return till St Leger Day” is trotted out with alarming regularity [once a year at a guess: Ed] with infrequent justification. This

year does not look particularly promising though. We’ve written much about the Greek debt crisis and its spreading contagion to the Eurozone, but other signs have been flashing. US markets experienced eight consecutive weeks of gains. Sentiment, as measured by an Investors Intelligence survey of financial newsletters, showed a bullish attitude from 53% of respondents, versus a 17% count on the bearish side. Amazingly, this was the lowest level of pessimism since 1987 – and we know what happened then. Cash levels in funds were down to 3.5%. “Lack of cash is a correction signal,” says the poll.

Markets have been fuelled by low interest rates and the promise of recovery. These low rates cannot last forever and we edge closer to the day that the direction of rates begins to head north once again. A bright spot however is in company earnings that are improving steadily. This is positive for corporate bonds and is not disastrous by any means for equities. Much depends upon which equities you hold, and where they are domiciled. Once again, Emerging Markets are difficult to ignore for their equities and their bonds.

“If You Like The Equities, You Should Love The Debt”

There is no little irony that the governments of the USA, the European Union and Japan are doing almost everything that they lectured their developing counterparts *not* to do during their crises in the 90s. As Bart Turtelboom and Karim Abdel-Motaal (co-heads of emerging markets at GLG) say, “Imagine if a Malaysian or Brazilian policymaker in the middle of a recession suggested printing money to buy banks, car companies and other so-called troubled assets – markets would have savaged them.”

Fidelity argue in a recent research note that Emerging Markets have transformed themselves in the past decade and now generally have solid and sustainable monetary and fiscal policies; commodity and manufacturing-related economic growth [Manufacturing: do you remember that? What does the bloated public sector actually *create* in our society? Ed]; much improved internal and external positions; macroeconomic stability of reduced inflation, lower interest rates and firmer currencies. Should the bonds of these countries be seen as any greater risk than those in the developed world?

In 1993 under 2% of the JP Morgan Emerging Bond Index was rated investment grade. At the end of 2009, this had exploded to 55%. As bonds are upgraded, so the capital value rises. Compare this to the downgrades in recent days of Greece, Portugal, and Spain and the concern over the future of UK gilts.

Is it too late to go into emerging market debt now if you're not already in it? That's been a question people have been asking throughout the last decade and the answer lies in the fundamentals as they exist today. The credit binge experienced by the "developed" economies has only just come to an end. Payback time has just started. Emerging economies have **had** their problems and are nowhere near as indebted. They are in a strong growth phase, fuelled by urbanisation and global trade. Western Governments face deterioration in their financial positions. Faster economic growth and higher savings rates in the "emerging" world will surely boost foreign reserves and trade surpluses, allowing their governments to improve their debt-to-GDP ratios.

Developed governments are likely to keep interest rates low – they have to. China, India and Australia have already started raising their rates. With interest rate differentials more likely to appear in the coming months, investors will push more capital from advanced to developing economies. Add to these factors the fact that emerging market bonds recovered very quickly from the 2008 global shock (although they were not immune at the time) and you probably have your answer about whether you are too late to invest in the asset class now.

It's All About Risk and Return

Bill Mott, manager and oft-quoted sage running funds for Psigma Asset Management, considers the 2010 surge in equity markets (until May, at least) to be akin to the rise pre-March 2000 which was also liquidity driven. He sees three possible developments as we progress from here, each with different results for investors. The outcome that he considers to be most likely is for a "tough but not impossible" UK economy with anaemic growth, where the UK grows more slowly than in the past but avoids slipping back into recession. This is far from ideal, but is better than option 2, which is regression into a double-dip recession. The most unlikely, according to Mott, is scenario 3, which sees a V-shaped recovery for which the 1st Quarter rally in stocks would be justified. We may already be witnessing that this latter possibility is running out of steam quickly.

Investment portfolios should be constructed so as to balance the risk of something happening and the return that one can receive from taking that risk. If we consider the probability of certain situations developing in the short term, maybe a clearer picture emerges of how to proceed.

Is it more or less likely that the growth in emerging markets will slow and the urbanisation programmes of China and India will be reversed? Will the problems being experienced by Greece and the other Eurozone countries be a flash in the pan and simply melt away over Summer? Will the UK national debt be rectified quickly now that we have had our election? Will the first budget after the election be a surprisingly easy one, or a surprisingly harsh one? Is it more likely that interest rates will stay as they are for the next year, or begin to rise? Does it make more sense to invest in economies that are strong, or in those that are saddled with debt? The answers appear to be surprisingly clear. Why then, do most people simply sit on their investments and hope for the best?

If you have any doubt about how a risk-adjusted portfolio should look, do feel free to ask us for our advice.

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