

# Investment Outlook and Review

## – Winter 2010



JLT INVESTMENT MANAGEMENT



Despite all the warnings of doom and gloom at the beginning of 2010, many of which proved to be true, the world economy, and world stock markets, had a reasonably positive twelve months, albeit with considerable volatility along the way.

The warnings are still there, the problems of 2010 continue into 2011 without many signs of resolution and new clouds are appearing on the horizon – but might the outcome for the year be similar?, namely a positive return but with short-term volatility.

A year ago, a forecast of a double digit return for the year would have been received with a certain amount of understandable scepticism. In our review last January we were expecting a positive year, but with a return somewhat less than was actually achieved. Suggesting something similar for 2011 might equally lead to raised eyebrows. As described in more detail below the known problems in the developed world and in China (and arguably in other Emerging Markets) have not yet been resolved.

But the key word is 'known'. As, for example, disappointing economic news was announced in the US, or another crisis has hit the Eurozone, or China has tried extra measures to dampen an overheating economy, markets in 2010 have reacted with short term setbacks, often quite sharply – but equally short-lived. The overall trend in markets was generally upwards, even if without much conviction.

Why? The most important reasons appear to be the vast amounts of cash in the system (only partly, but perhaps significantly, due to Quantitative Easing in the developed world) looking for a decent return in a low interest rate environment, and also the much better than forecast performance of corporate profits.

So the vital questions for 2011 seem to be – will interest rates remain at rock bottom levels; will corporate profits continue to surprise positively; will the Eurozone survive in its present form (or in any form?); will China continue to be the engine for growth in general (and commodity prices in particular).

The problem with this list is that it is very similar to a year ago. The world has moved on, but the scenery remains substantially the same.

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## FIXED INCOME

For most of 2010, despite all the well-publicised problems worldwide, yields on government debt in the major economies (US, UK, Germany, Japan) actually continued to fall as these markets were perceived to be 'safe havens' by investors looking for any home to place their cash. We did not expect this, preferring corporate bonds to government issues throughout the year, which at times held back performance.

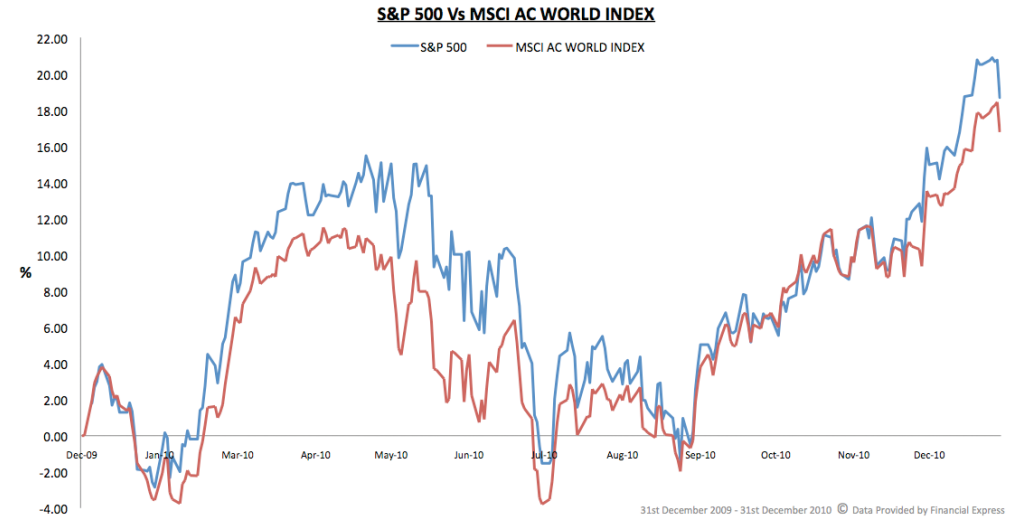
Only in the last couple of months has reality begun to assert itself. Concerns about sovereign balance sheets, inflation and economic growth have led to yields beginning to rise (and thus capital values falling) – something we have long been expecting. There seems little reason for this trend to reverse and government bonds in the developed world generally look an unattractive investment. Those issued by the peripheral eurozone countries look particularly unrewarding, despite the yields seemingly available, until (and if) some permanent resolution of the crisis is achieved.

Quality corporate bonds are a different matter. Rising corporate profits and balance sheet strength should lead to credit upgrades as the risk of default (already much lower than predicted after the Lehman crisis) recedes further. In many cases yields still provide enticing returns, even allowing for inflation, and there is no reason to think spreads (against government bond yields) should widen.

## U.S.A.

Despite occasional disappointing figures, employment, income and demand in the US appear to be increasing and GDP is now expected to rise by a more 'normal' 3.5/4% in 2011 (although some commentators are more pessimistic than this). Monetary conditions remain extremely easy (although some tightening later in the year must be a possibility), and corporations, and even many consumers, are awash with cash. The housing market remains stubbornly weak but the equity market rally has increased consumers' wealth and the savings rate is beginning to decline, adding to consumer spending.

Corporate profits have exceeded expectations, helped by the gradual trade-weighted depreciation of the dollar boosting exports. This should continue into 2011, as there appears to be little political will (or necessity) to tighten policy in the short term and thus reverse the overall weakness in the currency. Complaints from the US's overseas competitors about competitive devaluations are likely to be given short shrift for the time being (but are one of the clouds on the horizon mentioned in the introduction).



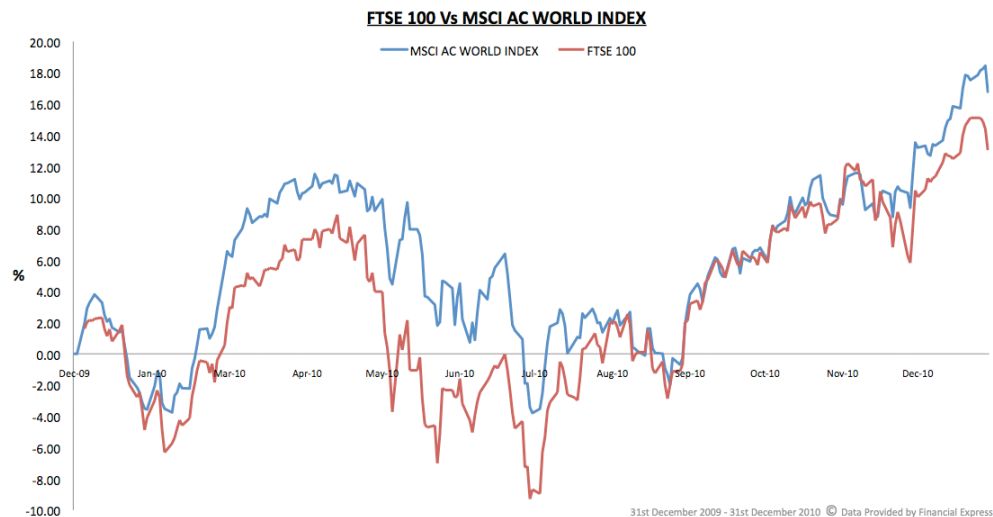
The above would imply a positive outlook for equities (but not for bonds). Analysts' expectations for 2011 are not high, as forecasts for GDP growth are in many cases lacklustre and probably too pessimistic. There is plenty of scope for positive surprises, and we believe positions in US equities should be increased, especially on any short-term setback.

## UNITED KINGDOM

As this document is being produced the first of the Coalition's major tax changes – the increase in VAT – is being implemented. Further changes will be made in April. The reduction in Public Sector spending has already claimed some major corporate victims – e.g. Connaught and ROK – and could claim more. Employment in the Public Sector is falling and will decrease significantly more as the spending cuts begin to bite in earnest.

The media are calling it an 'age of austerity'. But is this necessarily true? The private sector is performing better than expected and, as hoped, is increasing employment. Consumer confidence remains higher than might be thought possible given the outlook.

The key appears to be interest rates. Whilst these remain low (and despite the rise in inflation we do not expect them to rise significantly any time soon) mortgage payments also remain very low for the large percentage of customers on variable rates. If consumers are also still confident that their job is secure, even if salary increases are minimal, their outlook is likely to be less pessimistic than commentators expect.

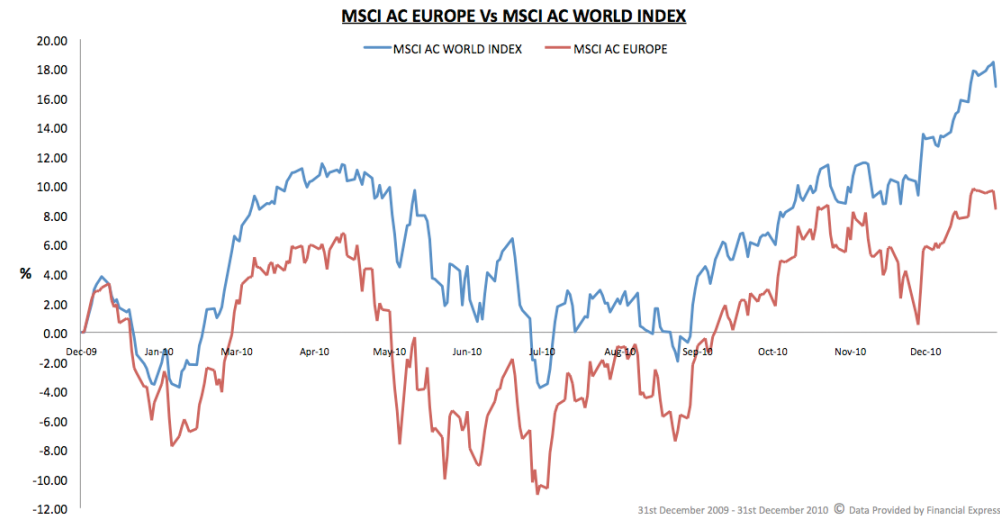


UK equities are much more dependent on overseas profits than those generated by UK plc and here the future looks more promising. One of the reasons for the good performance of the FTSE 100 in 2010 has been that corporate profits (and dividends) have often been better than analysts' forecasts. If this continues into 2011 (and it should be later in the year before disappointment might set in) the positive momentum being seen in the indices should continue. We still believe the FTSE100 will outperform (due to its worldwide profit profile) UK plc, where we remain negative.

### CONTINENTAL EUROPE

The Eurozone crisis is not over and will certainly provide further shocks to the system as time progresses. A situation where Germany (and its northern neighbours) are in something approaching an export-led boom, and the southern periphery remains firmly in recession, with more austerity measures still required to be implemented – has to be unsustainable.

Some changes to the eurozone seems even more inevitable now than a year ago, with all the 'solutions' of the last twelve months just tiding over the area until the next crisis hits. Politically this is anathema, but markets have a way of precipitating political decisions, and markets (especially bond markets) here hold the upper hand.



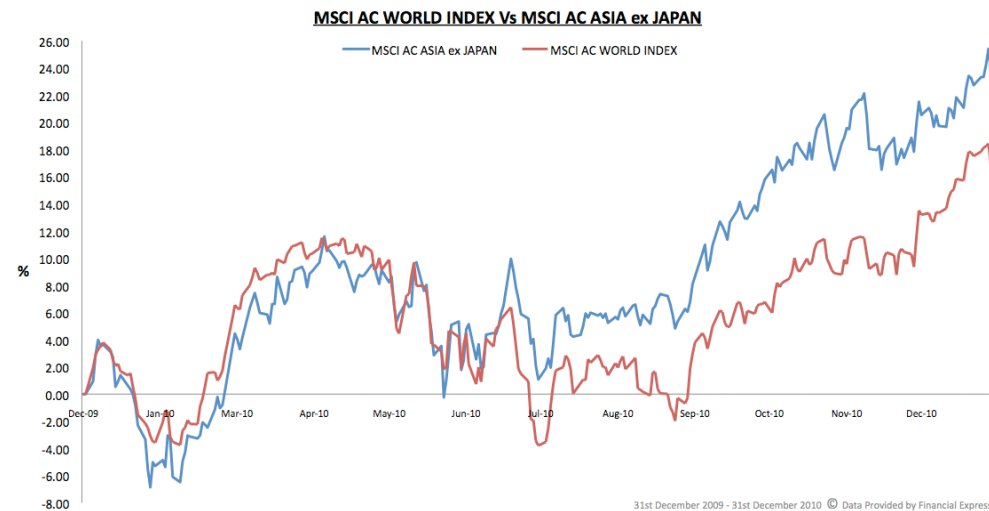
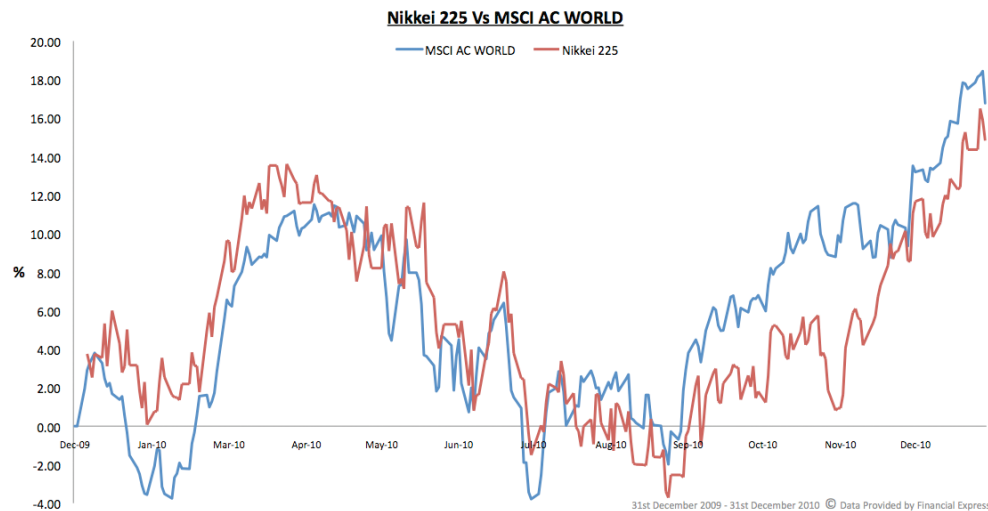
European equities, however, are a different matter. As elsewhere corporate profits (even in some of the underperforming countries) are proving remarkably resilient. As mentioned above, exports in many areas are well above expectations, and, even in Germany, consumer spending is increasing.

Investors in Europe have a wide range of countries and industries to choose from. Opportunities will arise throughout the region. Volatility is likely to remain high as and when politics intrude but we continue to be positive overall. Precedent (eg Argentina in 2001, Asia at the end of the 90's, and the UK regularly) has shown that currency breakups can be a major positive for both economies and markets. Only time will tell!

### JAPAN

It has become a truism to say that the Japanese market is cheap by any usual financial criteria but that a weakening yen is a prerequisite for investors, especially foreign investors, to return to a market that has proved so disappointing over the longer term. Yet foreign investors have been net buyers of the market for two months now, and the yen continues to strengthen!

In theory, a weaker yen should bring to an end Japanese domestic deflation. On several occasions in 2010 the Bank of Japan has toyed with monetary easing, and then changed



its mind. 2011 will provide even more ammunition for the critics of the BOJ and perhaps this year will see the stimulus that seems so necessary. Investors generally are still significantly underweight Japanese equities in their global portfolios (despite recent purchases) and if there are any signs that policy is changing, the positive momentum we have seen in recent weeks could continue.

Economically the numbers are already improving. Third quarter GDP has been revised upwards. Industrial production is rising, and even household consumption and retail sales are recovering. As elsewhere around the world corporations hold large amounts of cash, which in Japan usually leads to increased capital expenditure rather than higher dividends, for example. Corporate earnings have been strong and revisions generally upwards.

But investors have seen so many false dawns over the last twenty years that it will take some time before they are fully convinced!

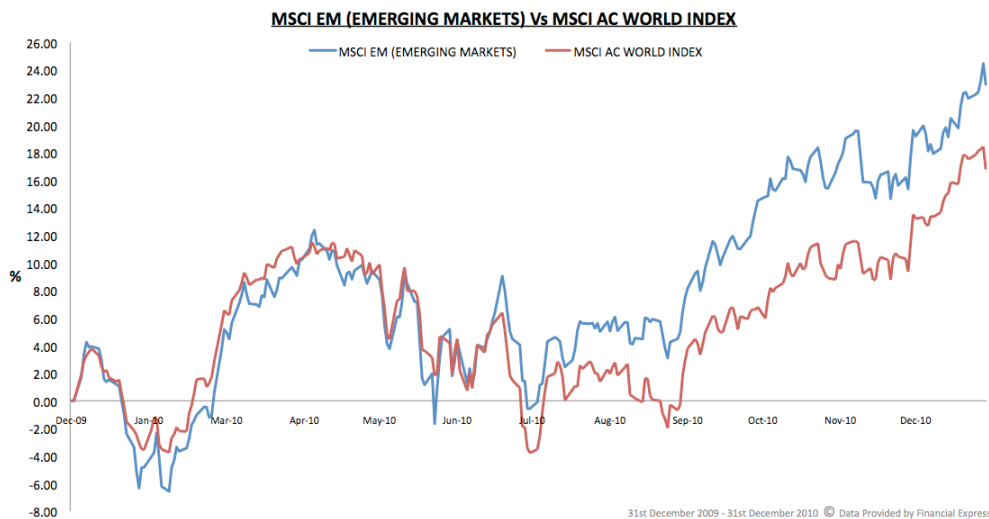
### ASIA ex JAPAN

Asian equities rallied at the end of 2010 as sentiment improved concerning a global recovery and despite worries over measures being taken in Beijing to combat inflation.

Inflation is the key in China where the authorities are aware that rising prices, especially of food, could lead to social unrest. This is an outcome that the government will do almost anything to avoid, and fighting inflation is now officially its highest priority. So we must expect further tightening in the coming months, which in turn will probably lead to further volatility in Asian markets (and presumably commodity prices) until Beijing is satisfied that the problem has been solved. How much of a negative this will be to China's GDP growth rate for 2011 is a moot point where bulls and bears seem to be evenly divided.

Whenever China tightens (or even makes noises to that effect) markets elsewhere in the region tend to react on longer term growth worries. But Taiwan and Korea for example are just as exposed to any US recovery, where forecasts are improving. Exports, as always, are the key factor, whether into China (and thus somewhat questionable in the short term) or to the developed world where the outlook is more promising.

The long term story of the growth in Asia, led by China (and India) relative to its western counterparts has not changed. There will be short term setbacks (for instance the North Korea / South Korea stand off will have to be resolved at some stage) but these should be used to build up weightings in the region.



## EMERGING MARKETS

Emerging markets, along with commodities, seemed to be everybody's favourite place to invest in 2010, to the extent that concerns began to arise of potential overvaluations – a 'bubble'. But we believe this largely misses the point.

The investment arguments for emerging markets (using the widest possible definition of the term) have not changed. Many of the countries in the investment universe have economies that are developing not just on the back of exports (traditionally commodity related in most cases) but also on a rapidly expanding domestic sector with incomes and consumption rising sharply.

In the short term, due to the inflows of capital being seen, this is leading to local currencies (eg in Brazil) rising at such a rate that measures are being taken to alleviate the problem. This is a problem of success, not failure, but nonetheless needs to be watched closely.

Investors in the sector have a wide (and increasing) range of regions, countries and industries in which to invest, many at different stages in the economic cycle. Opportunities abound. If there is a setback in the major equity markets around the world we could see a sharp fall in emerging market indices after the rises of last year. This should be used as a buying opportunity on anything other than a very short term view.

## CONCLUSION

In 2010 despite all the volatility seen in markets for most of the year, it was better to be invested in markets than sitting on the sidelines. In the short term we think this will continue, as the main alternative (cash) is still such an unattractive asset, and another possibility (gold) has performed so well that it is difficult to separate economic reality from emotion.

Until interest rates start to rise significantly (or until markets believe they are about to), thus making cash a viable investment again, or until economic forecasts suggest that any recovery is lacklustre (thus putting a question mark over company profit estimates), equity markets should continue to make headway.

As mentioned above the long term themes of Asia, Emerging Markets and Commodities have not, in our view, changed, although in the short term we would hope for a setback in prices before increasing positions. Share prices in the major developed markets (US, UK and Europe) do not look expensive and if world growth continues to recover should be a profitable investment.

Bonds are more problematic. Corporate bonds can be purchased for yield, but with little expectation of capital gain in 2011, and if rates rise later in the year capital loss will only be avoided if spreads against government bonds narrow – possible but not guaranteed. Government bonds look very expensive – but have done for some time now.

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