



Investment Outlook & Review - Summer 2008

By the iWM Investment Team

“THE RISK BALANCE FOR GROWTH IS STILL SLANTED ON THE DOWNSIDE, WHILE PRESSURES ON PRICES ARE ON THE UPSIDE”

THE GOVERNOR OF THE BANK OF JAPAN’S RECENT COMMENT (ABOVE) ON 3 JUNE 2008 HIGHLIGHTS THE TWO MAIN REASONS WHY THE PAST FEW MONTHS HAVE BEEN SO DISAPPOINTING FOR INVESTORS. GROWTH HAS BEEN WEAKER THAN EXPECTED WHILE AT THE SAME TIME INFLATIONARY PRESSURES HAVE INTENSIFIED RATHER THAN EASED, EVEN THOUGH THE WORLD’S MAJOR DEVELOPED ECONOMIES HAVE COOLED. AGAINST THIS BACKDROP MOST FINANCIAL MARKETS HAVE BEEN WEAK, WITH PARTICULARLY SEVERE FALLS IN THE SHARE PRICES OF MANY FINANCIAL COMPANIES AND SHARP SETBACKS IN THOSE EMERGING MARKETS WHERE INFLATION HAS GIVEN CAUSE FOR GREATEST CONCERN , SUCH AS INDIA.

The end of the “Goldilocks Economy”?

The buoyant financial markets of the past 20 years that have prevailed with only the odd interruption have been founded on benign conditions often characterised as the “Goldilocks economy”. By this term commentators meant that economic conditions have been near perfect for financial markets. Perfect, just as Goldilocks found baby bear’s bowl of porridge, neither too hot nor too cold. For a long time the world economy has been neither too hot, in the sense of unleashing serious inflationary pressures, nor too cold causing the economy to tip into recession. Developments in recent weeks have, however, conspired to make commentators question whether the global economy has paradoxically become both too hot and too cold at the same time. A doubling in the oil price over the past year, combined with consistently weak economic indicators in most developed economies, has led to fears that the era of the Goldilocks economy is over.

Behind the headline stories of plunging British and American house prices and rescue rights issues for banks lie growing pains connected with a dramatic changing of order within the global economy. The rapid economic development of the world’s most populous countries such as China and India over the past decade has been a remarkably smooth process. Their rapid development has not just boosted global growth, but has also helped to restrain inflationary pressures in developed markets. This has occurred through the steady reduction in the costs of manufactured goods and the provision of out-sourcing facilities that have acted as a restraint on wage inflation beyond geographical boundaries. Fearful of repeating the emerging market crises of the 1990s, when emerging economies were dependent on foreign capital which was withdrawn rapidly when

trouble broke, countries such as China and Russia have been producing vast surpluses of capital which has enabled western economies to over-consume and finance a borrowing binge that many now have cause to regret. Other factors have also been at work, not least the confluence of forces surrounding a remarkable period of globalisation, such as technological innovation and greater free trade. However, a number of these forces have reached a stage where their positive impact is lessening just at a time when major developed economies face a cyclical slowdown. This is providing policy makers in countries such as the US and UK with their sternest test since the recession of the early 1990s.

The challenge facing the authorities in developed economies including the UK and US is to tackle the deflationary forces caused by a severe credit crunch while simultaneously fighting inflationary forces caused by rising commodity prices. The test will likely be at its most difficult over the next six months. Over this period the secondary inflationary effects on prices will be feeding through from expensive commodities. This is likely to happen before the deflationary impact of the sharp slowdown in developed economies from the impact of the credit crunch on consumer demand and the housing market is felt fully and reflected in economic statistics. The key task for the authorities will be to prevent a significant deterioration in inflationary expectations becoming entrenched in the economy. As a result it is probable that the pivotal issue which will determine whether interest rates are increased will be the level of wage settlements.

We remain positive about the long term growth outlook for the global economy, and expect it to continue to be driven by the development of emerging markets. However, in the near term we would both expect and welcome a slowdown in the rate of economic growth in emerging economies. We would expect it in response to the rapid deterioration that has already occurred



in developed economies and in response to the rate increases we have seen in emerging economies, and would welcome it because it would help to take the heat out of commodity prices and thereby ease inflationary pressures. Rate increases are already taking place in emerging economies where inflation problems are most acute, such as India, and more rate rises are likely in the next couple of months. However, in developed economies where the deflationary impact of the credit crunch is being felt most, central banks will be more reluctant to act. An exception will be the hawkish European Central Bank, which is highly likely to increase rates, but the UK and US monetary authorities would prefer to talk tough but only act if there are convincing signs that inflation expectations and wage inflation are moving decisively upwards. To some extent the markets are doing the work of the central banks for them in fighting inflation. Not only are the "bond vigilantes" back, in the sense of higher government yields making credit more expensive, but the increasing difficulty of obtaining loans and mortgages, even at higher interest rates, means that monetary policy is effectively considerably tighter now than it was before base rates were cut earlier in the year. Moreover, with growing pressure on corporate profits, and evidence that the rate of unemployment is increasing, there are good reasons to suggest that pay settlements will be moderate. Unfortunately the UK is in a weaker position than most others to weather difficult times. The unpopular Labour Government is gaining a reputation for acceding to demands from pressure groups, and it remains to be seen how firm its resolve will be in resisting pay claims from the large public sector employers' unions on whom it relies both financially and electorally.

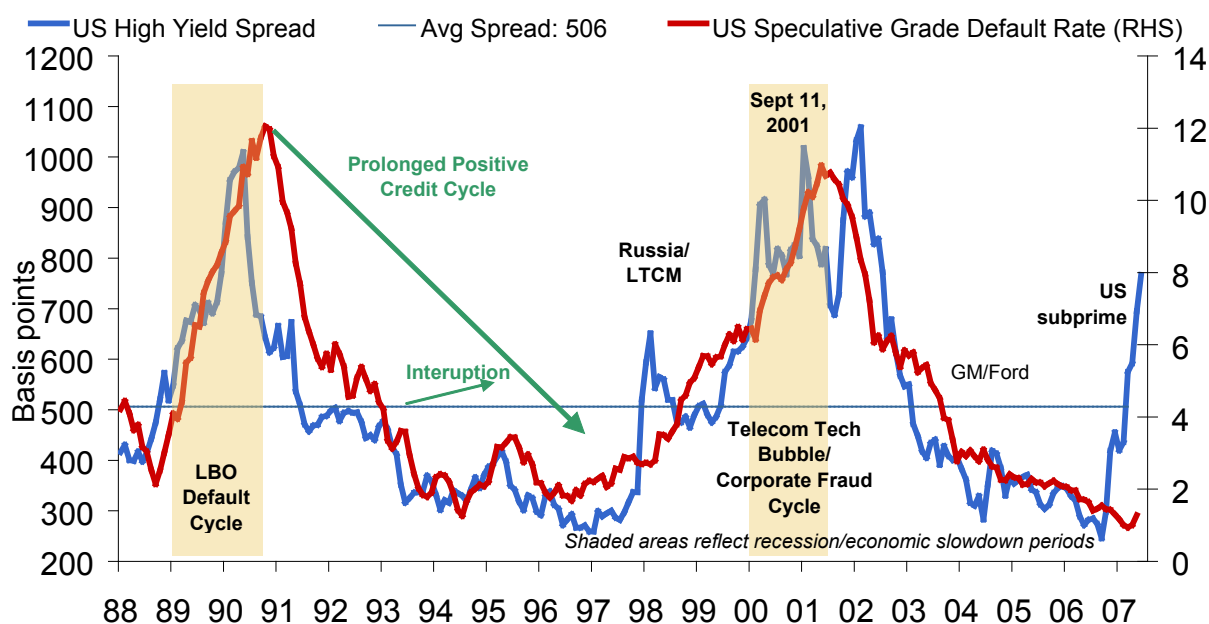
A tough economic environment reflected in treacherous financial markets

It has been unusually difficult to navigate a course through markets responding to worsening economic conditions. With very few assets performing well, diversified funds have struggled, and most hedge funds have recorded losses over the first half of 2008. While our investments in commodity specialist funds have proved successful, notably those invested in companies in the energy and agricultural sectors, this has been of only limited

comfort given losses seen in most other areas. Remarkably, the global mining sector has now outperformed broad equity market indices for nine years in succession; an unprecedented positive sequence for a major sector. In the light of this, and our feeling that some emerging economies will experience a deceleration in their rate of growth, we see risks of a setback for the sector even though we stand by the belief that the rapid development of emerging economies will keep commodity prices high and demand strong over the long term. However, we do not believe that investment success will be as simple as rotating out of the hitherto strong areas into the weak ones such as financials, property and consumer stocks. It is important to be highly selective, but we do believe that poor markets have thrown up some outstanding investment opportunities. One of the most interesting areas of opportunity is fixed interest markets.

The following chart from Invesco repays careful study. It shows in the light blue line the additional yield investors have received over the past twenty years from holding US High Yield Bonds (issued by American companies) compared with holding US treasuries (issued by the American Government). Alongside this line is a red line showing the percentage of corporate bonds subject to default, in other words those issues by companies unable to service the interest or repay their bonds at maturity. Understandably there is a very close correlation between these two lines for the obvious reason that investors should be rewarded with a higher premium yield in difficult times when there is a greater risk of not receiving what they are due.

It is immediately apparent from this graph that there has recently been a huge upward move in the additional yield being paid for holders of corporate bonds compared with US treasuries even though defaults have remained low. The critical question to answer therefore is to what extent the red line will rise in the future. In other words, are fixed interest markets correctly anticipating a very severe deterioration in the ability of companies to service their debt, or are the rewards from holding corporate debt an opportunity worth seizing?



Recent meetings with some of the most highly respected bond managers in the country have left us feeling very optimistic that fixed interest markets now offer exceptional opportunities, not just to generate very attractive rates of income, but to also make capital gains. Paul Read of Invesco Perpetual acknowledges that we “continue to be in, but past the worst of, the credit crisis”, and as the worst is behind us he feels that fixed interest markets are offering among the best value he has seen in his career. While it seems certain that the level of defaults will rise, the degree to which they rise should be far less than they were in 1990/91 or 2001/02. In the former period the levels of interest rates, inflation and unemployment were far higher, and the global economy lacked the strong growth impetus from emerging markets that it now has. In the “TMT” bust of 2001/02 most of the companies that got into difficulty were highly speculative in nature, being comparatively new and untested telecommunications or technology companies. There are now comparatively few speculative companies with major bond issues, with the exception of bonds issued during large highly leveraged private equity deals in recent years. Indeed, the corporate sectors in the UK and US are generally in good health. Moreover, in those areas such as financials where there are stresses on balance sheets, companies are acting to shore up their position by raising equity finance, which has the effect of improving the protection for creditors including bond holders. Deutsche Bank and Moody’s calculated recently that 19% of investment grade bonds would need to default over the next five years for the sterling investment-grade market to underperform government bonds over the next five years. The worst cumulative five-year default rate since 1970 has been 2.4%, and the average is just 0.8%.

Against this backdrop we believe that actively managed strategic bond funds managed by experienced investors should be able to generate attractive rates of total return over the year ahead. Probably the greatest opportunities lie in investment grade and secured loans, although following the back up in government bond yields in response to fears about inflation and the risk of higher interest rates, some government bonds offer the prospect of decent returns with a comparatively low level of risk.

Our strategy in equity markets

Richard Buxton, Schroder’s highly regarded UK equity fund manager, commented recently that “the market has priced inflation problems in” and has also “priced in the recession we are entering”. In other words, it is now possible to be both realistically negative about the gloomy outlook for the UK economy while at the same time believing that many UK shares are attractive investments. Studying the past can be a useful guide for the future and the UK’s experience in 1992 around the time of sterling’s ejection from the Exchange Rate Mechanism has lessons for the current situation. The retail sector underperformed the stock market for three years leading up to the 1991 recession when consumer spending was strong, but then outperformed during the recession itself. Moreover many shares performed strongly through the tough times, with share prices going up even when dividends were being cut and profits were under pressure. Sterling’s ejection from the ERM was a catalyst for a better stock market and sparked a change in the internal dynamics in terms of what areas were performing best. While it is always hard to spot a catalyst ahead of it taking effect, a turn could be triggered by a slowdown in emerging economies

easing pressure on commodity prices and interest rates. Equity income funds will be beneficiaries of this change when it comes. These funds have struggled in recent markets, but it is now possible to hold a portfolio of good quality shares with an attractive yield relative to government bonds and cash. Once investors rediscover an appetite for risk, and the risk premium on equities moderates, good quality yield stocks should be re-rated rapidly.

We have trimmed exposure to emerging markets in recent months, and focused our emerging market exposure mainly in funds that are absolute return or yield orientated vehicles. Emerging markets are now valued at a premium to developed markets and are thus vulnerable to bad news. The extraordinary reverse seen in the fortunes of the Vietnamese equity market, which fell every day in May and much of June, is a reminder of the downside risks when foreign investors seek to exit a market. Even among the largest emerging markets with much better liquidity, such as China and India, they have had substantial falls within a short period. Nevertheless, further setbacks in emerging markets should be seen as opportunities to rebuild exposure. Two themes within emerging markets to focus on are those countries that are net producers of commodities, and companies within emerging economies that benefit from the huge requirements for infrastructure development.

Among developed markets we continue to favour Japan and the US over continental Europe. Japan has been the best performing of the world’s main equity markets in 2008, although sadly this has meant that it has fallen less, rather than achieving positive returns. Japanese equities look undervalued on most measures, with a majority of Japanese share prices trading below their book value, and the dividend yield on the Japanese market standing at a premium to the yield on Japanese government bonds. Furthermore, while inflationary concerns are undermining many of the world’s financial markets at present, Japan’s economy and equity market should benefit from a pick up in the rate of inflation given the country’s prolonged battle with deflation. Inflation should encourage Japanese consumers to increase spending and to switch cash into equities. The latter point is significant given that over half of Japanese households’ financial assets are held in cash.

Currencies

Foreign exchange markets have recently been a comparative backwater from the dramas affecting bonds, equities, commodities and property. Indeed, the level of volatility in currency markets has actually fallen in recent months while volatility has been rife in other areas of financial markets. We have been consistently negative about the outlook for sterling over the past couple of years, and although the pound took longer to fall than we expected, it has now weakened by around 10% over the past twelve months on a trade weighted basis. Given the challenges faced by the UK economy it is hard to mount a bullish case for sterling even after this weakness, although the relative performance of other currencies may be on the point of changing. The euro has been the strongest of the world’s major currencies, and has been buoyed recently by the prospect that the European Central Bank will increase interest rates soon. However, looking further ahead, it seems likely that market forces will begin to favour the US dollar. The US economy should emerge from its sharp cyclical slowdown later in the year at a time when the European economy is slowing in reaction



to its comparatively tight monetary policy and strong currency. Furthermore, a significant improvement in the US current account deficit has been occurring, with the level of exports rising relative to imports. This trend would be even more evident were it not for the huge jump in oil prices and the consequential impact on America's large bill for imported energy. The US authorities are also now more concerned to prevent their currency weakening. Ben Bernanke, the Chairman of the Federal Reserve, surprised investors recently by commenting on the need for a strong US dollar, having previously been seemingly happy to see a weak dollar to stimulate exports. The reason behind Bernanke's comment was probably concern that a weak dollar was exacerbating inflationary pressures at a time when the Federal Reserve is anxious to avoid needing to raise interest rates given the still fragile state of the US financial system.

Property

The sharp change in expectations about the direction of interest rates during recent months proved very negative for physical property, and quoted property shares. In the first few months of the year the property sector had been one of the best performing areas of the UK market, helped by the fact that it had already been heavily sold down, and was expected to be a beneficiary of interest rate cuts. The deteriorating economic outlook, which has taken a toll on expectations about future levels of rents and voids (when tenants cannot pay their rent), has undermined the property sector along with the change in outlook for interest rates.

Broad measures of UK commercial property markets, such as the IPD Index, show that commercial property prices have already fallen by around 17%, and remain on a downward trend. The deterioration in the level of liquidity, which makes the task of valuing property problematic, also means that the market is more opaque than usual. The derivatives markets are already pricing in a fall in values at least equivalent to the 27% decline in peak to trough prices seen during the slump in the early 1990s, when interest rates were over 10%. The sell-off in the quoted property sector has been more rapid and severe than during the bear market seen in 1990-93, and is beginning to look overdone. In the recession during the early 1990s rents fell by around a fifth, and are still now around a third lower in real terms even after the strong property market of up to a year ago. Furthermore, aside from legitimate fears of oversupply in the City of London, there is far less new supply due to come on stream than there was in the last downturn. Awful sentiment towards property is not confined to the UK. Markets that were subject to over-building or exceptional price rises such as the US and Spain have been hit very hard. Even those economies like Germany and Japan, where property prices were recovering following a period of prolonged slump, have seen that recovery interrupted and quoted property securities sold down.

Without doubt investors are suffering a hangover from the property bull market that ended in mid 2007. Some of the losses sustained during this hangover have been huge. Many investors are still locked into open-ended property funds that shut their doors to redemptions, or in physical property for which the market

has dried up along with the price having fallen. Downward pressure on rents and prospects for increasing vacancies and bad debts in a more challenging economy are risks that continue to concern property investors. However, we believe it is right to be an opportunistic buyer of the sector now that yields of physical property have risen sharply to attractive levels and ratings of many property shares discount an outright recession. Thames River's veteran property investor Chris Turner recently wrote with regard to property markets that "we think that the point of maximum pessimism is still ahead of us, but is getting closer". As it is always difficult to time the precise turn in a sector, it is worth having exposure so as to participate in a recovery, particularly when it can be purchased via closed ended funds at steep discounts to their net asset values. Such opportunities include the un-gear'd TR Property Investment Trust, whose shares recently traded at a discount in excess of 20%, and a number of UK listed property funds invested in overseas property markets that are now trading at discounts in excess of 50%, although many of these have risks associated with being geared.

Conclusion

The great economist John Maynard Keynes once said that "successful investing is anticipating the anticipations of others". Along with most investors we failed to anticipate fully how severe the credit crunch would become, and how sharply commodity prices would rise at a time when the world's major developed economies were slowing. While we have reduced some positions in geared funds that would be most vulnerable should conditions deteriorate even more sharply than the gloomy consensus now expects, we feel most asset prices are offering decent value notwithstanding a difficult and risky economic environment for investors.

Without doubt the environment has deteriorated and has proved to be worse than we and most other investors expected. Nevertheless, the swift movement in money markets to discount a sequence of rises rather than further falls in US and UK interest rates seems too bearish. Financial markets have considerable scope to regain much of their lost ground once forward interest rates fall back as would seem likely by the autumn. This change will probably follow a decline in the oil price, an event most likely to occur when the sharp slowdown seen in developed markets takes the heat out of emerging economies. In the meantime, sentiment among investors is understandably wretched, so there is a risk that continued selling forces prices still lower. However, deeply oversold conditions are already present in the closed ended fund sector, and while there have been times in the past such as 2002 when these have persisted for a while, they have normally been a good time to invest.

