



## Investment Outlook & Review

### Winter 2010

IN 2009 THE IIMIA DISCRETIONARY MANAGEMENT MODEL ASSET ALLOCATION ADDED VALUE RELATIVE TO THE APCIMS PRIVATE INVESTOR INDICES; WHEN COMBINED WITH STRONG FUND SELECTION THIS HAS RESULTED IN CONSIDERABLE OUTPERFORMANCE RELATIVE TO THE INDICES. SIGNIFICANT CONTRIBUTORS INCLUDE:

- DIVERSIFIED FIXED INTEREST EXPOSURE: RELATIVE TO APCIMS THE PORTFOLIOS WERE UNDER WEIGHT GILTS AND OVERWEIGHT CORPORATE BONDS.
- DIVERSIFIED EQUITY EXPOSURE: RELATIVE TO APCIMS THE PORTFOLIOS WERE UNDERWEIGHT UK EQUITIES AND OVERWEIGHT INTERNATIONAL EQUITIES, IN PARTICULAR ASIAN AND EMERGING MARKET EQUITIES.
- STRONG STOCK SELECTION INCLUDING IMPRESSIVE OUTPERFORMANCE BY OUR CHOSEN FIXED INTEREST, ASIAN AND EMERGING MARKET FUNDS.

WE CONTINUE TO BELIEVE THAT LONG-TERM UK INVESTORS WILL BENEFIT FROM PORTFOLIOS WHICH ARE WELL DIVERSIFIED BY GEOGRAPHY AND ASSET CLASS. THE FOLLOWING REVIEW AND OUTLOOK GIVES AN INDICATION AS TO WHERE WE BELIEVE PORTFOLIOS SHOULD BE POSITIONED HEADING INTO 2010.

2009 has been an interesting year! Twelve months ago the world economic system was still in crisis. Co-ordinated government response was awaited and was delivered – massive liquidity injection, interest rates at or near zero, tax cuts in some areas and increased government spending.

The risk of the crisis worsening and world trade imploding still further was averted to such an extent that, from the spring, investors' showed increasing willingness to take more risk and markets worldwide recovered from their lows – and with only minor corrections along the way continued to rally for the rest of the year.

Despite the renewed optimism the rise in markets has been viewed by many professional investment managers with a great deal of caution. They believed – and largely continue to believe – that the rapid recovery was not justified by fundamentals and would end in tears. As a result many will end 2009 with a larger-than-average level of cash in their portfolios.

The main questions that need to be answered during 2010 concern the rate of economic recovery in the developed world, the continuation of above-average growth in emerging market economies (which has a direct bearing on commodity prices – especially metals), and what will happen when (not if) governments around the world reverse some of the measures taken in recent months to alleviate the crisis.

The latter point is particularly important. The problems of debt repayments in Dubai, Greece and elsewhere have highlighted that some aspects of the crisis still remain. These were not a surprise as warnings have been signalled for months, but they have taken longer to come to fruition than expected. Other countries, the UK being a prime example, could find themselves in similar difficulties if the correct policy measures (as perceived by market operators) are not taken sooner rather than later.

The recession may be over (likely, but not yet a certainty) in the major developed economies, but there is significant disagreement amongst politicians, economists and investors about the shape and durability of any recovery. Many governments need to provide further stimulus to support a recovery in their economies, but are unable to fully do so (if at all) given the debt burden already in place at the end of 2009.

This debt burden of countries, many companies, and individuals, is unsustainable. A legacy of the last decade, this will have to be reduced sooner rather than later and whatever measures are taken will necessarily put a dampener on economic activity in the short to medium term (and may have a seriously negative effect on consumer confidence, which has picked up sharply in recent months). Where policy responses have been lacking in their credibility markets have justifiably been nervous.

Many investors are concerned that a major debt and / or currency crisis has just been postponed, not prevented and that 2010 will have to see a resolution. This is a Western, developed world problem. Despite some excesses being seen in China, the Eastern (and elsewhere) developing world has largely avoided the worst of the problems and this should continue, albeit at a slower pace in the short term.



A further weakening of sterling and the dollar (the latter maybe questionable), coupled with a strong euro are possible outcomes of the policy responses expected in the coming months. This will accentuate the problems already being experienced by the weaker members of the Eurozone – Ireland, Spain, Portugal, Italy and Greece (see below).

Growth is paramount, both in scale and in sustainability. The recovery in stock markets around the world seen since March 2009 has already seemingly discounted any recovery in 2010. It will take time for reality to catch up with expectations and there is room for disappointment in the earlier part of the year if some of these expectations are not met. As the year progresses, if corporate earnings remain robust, then markets could continue their advance.

## Fixed income



This proved to be a 'storm in a tea cup' in the short term but highlighted the weight of debt – government, corporate and private – that overhangs the global economy needing to be unwound. Dubai and Greece are out in the open – others will assuredly follow.

Government bonds need to be watched closely. Issuance of new debt in 2010 will be huge and prices could deteriorate as a result, if buyers demand higher yields. Whilst inflation remains low (a situation we expect to continue for the foreseeable future) bonds in general still provide a good return, but the composition of bond portfolios may need to be changed later in the year. Corporate bonds, of all qualities, have seen vast amounts of cash flowing into the sector as investors worldwide have chased yield. The bulk of the capital gain appears to be behind us, but the sector still provides above-average income and can be held for this for the time being.

After a year in which bond markets in general, and corporate bonds in particular, performed very well the announcement in November by Dubai World that it was unable to honour repayments on one of its subsidiary's bonds and needed to restructure, shocked and unsettled markets.

## U.S.A.



experiment (so too other major developed economies), the Fed central bankers, fearful of the double-dip recession, will be in no hurry to raise interest rates too soon, as to do so is likely to stifle the momentum in the economic recovery.

The US is still the most important contributor to global growth and a significant part of that is driven by the consumer, so taking money from the pockets of the already cash-strapped American would be dangerous.

Nevertheless, there is a great deal of optimism about the outlook for the US economy over the coming year and Wall Street has enjoyed a strong recovery since the S&P 500 index low point in March 2009 (see chart), suggesting that investors are overcoming their fears of holding risk assets. We mustn't get carried away – economic measures of productivity are still below their average readings, and an index below its level of 10 years ago, means a US investor has lost money over that timescale. However, the US has done what everyone expected – thrown its weight behind the crisis to fix it quickly, with businesses cutting costs, deleveraging and reducing inventory. Therefore, we see the market as offering pockets of good value, and earnings expectations for certain sectors going into 2010 are high. It will be those well-managed core businesses with improved cash-flows and underlying profitability that stand to gain ground in the coming months, whilst the delayed effect of reduced fuel costs from 2008-9 should boost consumer confidence.

In a little over a year since Lehman Brothers went bankrupt and the US government rescued the insurer AIG, we have seen the implementation of an unprecedented fiscal and monetary stimulus package where the Federal Reserve cut interest rates to near zero and the Treasury has printed in excess of \$700bn. This action ensured that the US economy avoided a 1930s-like depression and recovered quickly from the liquidity crisis, and indeed emerged from recession by the third quarter of 2009 ahead of much of the rest of the world.

Economic indicators have continued to improve or provide positive surprises, with retail sales and business activity recovering and the growth in jobless numbers slowing. This generally heralds the re-emergence of inflation, but with the US seeking an exit strategy from the untested Quantitative Easing

## United Kingdom



Any forecasts for the UK in 2010, both economically and for the stock market, are complicated by the prospect of a General Election, which must be held by early June, but could be as early as the end of March.

Everything discussed in the general comments above are accentuated in the UK. A decade of excessive liquidity and borrowing needs to be reversed. Also the quantitative easing being employed by the Bank of England to stimulate the economy will at some stage need to be turned off. Debt

issuance will be massive and could be expensive. Interest rates may have to rise sooner than any government might like and Treasury receipts need to increase by one means or another – necessitating a rise in direct or indirect taxes. A new government, of whatever hue, will have to make some very difficult and harsh decisions very quickly – decisions that are unlikely to be made prior to the election.

These measures do not augur well for the short-term outlook for UK plc – ie those parts of the economy dependent on domestic activity. However, the main indices are much more overseas oriented, especially the FTSE 100, and with a weaker currency and better growth elsewhere in the world profits for many of its constituents could continue to grow, allowing the index to prosper.

Institutions and investors still hold large amounts of cash. Rights issues have absorbed some, but much of the rest is on deposit, earning little to nothing. At some stage (after the election?) this could well be reinvested in the market. The second half of 2010, on the face of it, could look more encouraging than the first. Also large, international, companies seem to have better prospects than smaller, more domestically oriented investments, at least until the economic outlook is clearer.

## Continental Europe



Continental European markets have risen in line with the rest of the world, aided by a combination of ultra-low interest rates, 'non-standard measures' (the European Central Bank's euphemism for quantitative easing) and better-than-expected corporate earnings announcements.

However all is not well across the Eurozone. As mentioned above, Greece's well publicised debt problems are the first, overt,

signs of the strains apparent in Portugal, Spain, Italy, Ireland and elsewhere. The ECB, with its northern European (ie German) bias towards caution is already showing signs of wanting to rein in some of the stimulus measures taken in the last year, and this is the last thing needed by the southern members of the European Community.

The ECB's known hawkish stance (where any chance to increase interest rates will be taken with alacrity) has been one of the contributory factors in the strength of the euro against both the dollar and sterling. This has caused some headaches for exporters, but has so far largely been offset by cost-cutting measures taken early on in the crisis. Many European companies have been far more agile in dealing with problems this time round than in previous recessions.

Growth in 2010 will, as elsewhere, remain problematic, and will diverge in different economies across the Continent. How individual governments deal with the resulting crises (like Greece) will largely affect the course of markets during the year. But many companies continue to do well and the area as a whole should not be ignored.

## Japan



Japan has had an odd year in markets. A strong first half followed by a weak summer, then some recovery in the last few months. There at last seems to be a consensus in Japanese government circles (a new, largely untried, government) that significantly more should be done to boost the economy and to try and limit the strength of the yen. The new DPJ government needs to win the Upper House in June to consolidate its position, and some signs of progress are required before then. More market-friendly measures are being implemented (no more 'bridges to nowhere' however) and beginning to take effect.

In the market valuations, by all normal international standards (e.g. Price Earnings ratios, Price-to-Book, Price-to Sales) have fallen to levels not seen for many years. The key is the value of the yen. It is noticeable that any sustained weakness against the

dollar leads to a rally in equity prices. If earnings recover in 2010, as many commentators believe, and the yen weakens somewhat this could be the one large global market that surprises on the upside, whatever happens elsewhere.

## Asia Ex Japan



The recovery in investors' appetite for risk which has been seen since the market lows in the spring continued, with minor wobbles, over the fourth quarter. There is a close correlation with the path of the US dollar, with a stronger currency usually leading to a sell-off in emerging markets and vice versa.

Throughout the year, China will remain the main focus within the region both with local and international investors. To date the authorities in China have managed to both inject vast sums of cash into the economy during the crisis last year and then recently

to start to claw back some of the funds, all without, apparently, any signs of destabilisation. Other measures are also being taken to moderate any effects of too much liquidity remaining in the system. For an economy of China's size this has been impressive, and is significantly ahead of similar measures being attempted elsewhere. This has all been viewed positively throughout the region as it augurs well for continued growth in 2010 and beyond.

One brake on performance has been the high number of new listings on exchanges around the region, often of property companies with too optimistic a price target that have sharply underperformed after listing and somewhat dampened the enthusiasm of the private investors in the area. However, generally stock-picking ideas have abounded, with corporate profits recovering quickly after the falls last year due to de-stocking and dividends being increased. The major indices have reflected this, as seen above. This has been particularly true in Australia, which never fell into recession and where interest rates have already been raised to combat any incipient inflation.

Traditionally Asian markets do well leading up to Chinese New Year before taking a breather and then picking up later in the year. Subject to no geo-political shocks this pattern should be repeated in 2010, albeit to a lesser extent than in 2009, unless economic growth is more robust than forecast.

## Conclusion

As can be detected in the above paragraphs we remain cautious of markets, both equity and fixed income, as we start 2010. Too many things need to go right, and little has to go wrong, for markets to continue the rise we have seen in 2009. As mentioned the measures that will need to be taken by developed nations' governments to counter the actions of the last eighteen months will not be painless. How companies and consumers react to the belt-tightening that will be necessary will determine the future course of corporate profits, which have been on the whole surprisingly healthy so far (due in part to cost-cutting – an exercise that cannot continue indefinitely). These in turn will influence directly equity markets around the world.

Using the widest possible definition of the term, we continue to prefer Asian and emerging markets to elsewhere in the world. We are in the midst of a long-term shift in economic (and political?) power from the old developed world of the West to the newly developing world of the East. In the short-term, emerging markets are somewhat overbought, attracting far more investors' interest than ever before (but still small in most portfolios' asset allocation) which could prove volatile as the year progresses, but any fall should be used as a buying opportunity.

Elsewhere, in the developed markets, we believe the US, Japan and Continental Europe all have a place in portfolios, with Japan, as mentioned above, as the possible positive surprise for 2010. We would be underweight in the UK, where the problems, and the potential solutions, seem unlikely to boost investors' confidence.

We would still maintain holdings in bonds, especially corporate bonds, to provide income in portfolios as well as an element of stability in what could be a very volatile world. But as the year passes the composition of the bond portfolio could be changed (from government securities to corporate) and then reduced if and when the move to equities becomes more obvious.

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