

MARKET OVERVIEW AND INVESTMENT OUTLOOK

OCTOBER 2011

Market Overview

Over the three months to the end of October markets were exceptionally volatile. Concerns over global growth and the ability of European policymakers to come together to produce a definitive solution to the Eurozone debt crisis resulted in a sharp sell off in 'risk' assets (ie equities and corporate debt). However better macroeconomic news from the US and China steadied markets and the announcement by France and Germany of progress on attempts to resolve the difficulties in the Eurozone resulted in a sharp rally in these assets during October.

This has meant that the FTSE All-Share fell 'just' 4.6% over the period (at one stage the index was down 14.6%).

In local currency terms, US equities were relatively robust (S&P 500: -0.2%) as the third quarter results season saw companies beating already reduced expectations. Asian and Japanese markets were the poorest performers (MSCI Asia ex Japan: -9.7%, MSCI Japan: -9.0%).

The best asset class to have been invested in was UK Gilts, which returned 6.1% over the three month period. Investors reacted to reductions in growth forecasts by buying Gilts, despite poor news concerning near term inflation.

As the sensitivity to risk heightened, UK Corporate Bonds began to underperform Gilts, however, this was partially reversed in October.

With equity markets having contracted significantly, and the spread between high yield debt and sovereign debt widening, it is important to ask what is being priced into markets.

The FTSE All-Share is now trading on a Price/Earnings (P/E) ratio of around 9.7 times and has a dividend yield of 3.6%. This dividend yield can be compared with the 10-year Gilt yield of 2.3%. The differential between the two figures, in post war terms, remains exceptionally high. Other valuation measures also suggest that UK equities relative to Gilts look good value.

However, it should be noted that the trough in P/E ratios during the systemic equity market crash of 2008/09 was significantly below current levels, which suggests there could still be downside should the current economic slowdown slide into something more structural. As growth in the developed economies falls to close to stall speed, the risks to the downside rise as the ability to contain systemic shocks falls.

The oil price fell 6.2% during the period, whilst the gold price reacted positively to the enhanced uncertainty, rising 5.3%.

Property was relatively strong, putting in a positive return for the three month period, with the IPD UK All Property Index returning 1.3%.

Source: Cornelian Asset Managers October 2011

Investment Outlook

Following the sharp rally in equity and corporate bond markets during October (as investors started to believe that Eurozone policymakers were beginning to make progress, and some macroeconomic data releases started to suggest global economic growth may be stabilising), the Greek Prime Minister pressed the nuclear button and called for a referendum on the Greek bailout package. This referendum, if it comes about, will take time to organise. Thus, significant uncertainty is likely to persist for the next couple of months. Although the referendum question will concern accepting the bailout package in its entirety, it is in fact a referendum on whether Greece should remain in the Euro. A no vote will almost certainly result in the disorderly default of Greek debt, the triggering of insurance payouts on this debt and a run on the deposits of Greek banks (a disorderly default on Greek government debt would make the Greek banks insolvent). Unbelievably, the stakes have just been raised yet again.

The frustrating issue here is that the Eurozone policymakers did put together a package which was taken well (at least, initially) by the markets. Successes included plans for the banks to recapitalise and a sizeable haircut to Greek debt, made possible by the voluntary involvement of the private sector. It wasn't perfect, but it was a starting point from which the plans could be further developed. With the Greek referendum call, this plan is (at best) put on ice. At worst, the IMF may be legally obliged not to participate in the next Greek cash call, as the deal has not been ratified.

The next notable events occur later this week (1st week in November). Firstly, the G20 meet and must announce significant measures designed to help stimulate global growth, and secondly, the Greek government will be subject to a self inflicted confidence vote in their parliament.

Our view is that the government (which only has a slender majority in parliament) could fall shortly and elections could be triggered (thus, avoiding the referendum). However, the position of the main opposition party is currently against the bailout deal, but it should be noted that they have not put forward any alternative solution.

There is a belief that a referendum will reject the bailout package as some 60% of the electorate are against the deal. However, this is too pessimistic as something like 70% of the electorate wants to stay in the Euro. Perhaps, at last, the electorate will be presented with a realistic assessment of what a disorderly default will mean to the Greek economy.

The risk is that this crisis continues and the contagion shifts to Italy. Clearly, Italian sovereign debt yields are continuing to rise. This may force the ECB to increase its purchase of government bonds that are showing signs of stress.

What is clear, regardless of short term policy announcements and gyrations in stock markets, is that the economies in the west will have low growth and high unemployment for the foreseeable future, as it will take a significant amount of time to readjust debt levels at the consumer and government levels.

The good news, if it can be called that, is that markets are already pricing in a downturn (if not a systemic crisis) and companies have taken the opportunity over the past two years to restructure aggressively and pay down and/or refinance their debts. It is encouraging that inventory levels are not excessive, as this means that should growth slow meaningfully, the down time required to be taken by companies to clear unwanted inventories should be much reduced compared with 2008/9 and this would help mitigate the scale of any associated downturn. Furthermore, companies have been through this kind of shock recently and know exactly what to do, if it becomes necessary.

In a lacklustre economic environment equity and debt investors will search out and prize income, growth and cash flow visibility more highly. This suggests that investment grade debt and higher dividend yielding, multi-national businesses with solid growth credentials will be valued more highly, and our portfolios increasingly reflect this view.

In the near term, the output from the G20 meeting will have a critical role in driving confidence in the outlook.

Risk Warning

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