JOHNSTON CARMICHAEL

MARKET COMMENTARY

JOHNSTON CARMICHAEL FINANCIAL SERVICES LTD

CHARTERED FINANCIAL PLANNERS

MARKET OVERVIEW AND INVESTMENT OUTLOOK

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Market Overview

Over the three months to the end of November markets have been on a rollercoaster ride as the Eurozone debt crisis lurched from one predicament to another and fears that the major political parties in the US were so split that decisions to aid the US economy could not be taken. Economic growth forecasts for the Eurozone area have been scaled back dramatically and this has only increased fears that debt reduction targets are too optimistic and further austerity measures will be required. However better macroeconomic news from the US and concerted action by Central Banks to provide liquidity to the banking sector has steadied markets.

Over the period the FTSE All-Share returned 2.1%, but volatility was such that, within the time frame reported a market rally of 15% was witnessed.

In local currency terms, US equities continue to perform relatively well (S&P 500: +2.7%), helped by encouraging macroeconomic data releases. Asian and Japanese markets were the poorest performers (MSCI Asia ex Japan: -6.9%, MSCI Japan: -4.8%) as questions over the pace of Chinese growth surfaced.

The strongest asset class to have been invested in was UK Gilts, which returned 6.7% over the three month period. Gilt prices were supported by an announcement from the Bank of England of another Quantitative Easing package and the perception that the UK is a relative safe haven. As the sensitivity to risk heightened, UK Corporate Bonds underperformed Gilts.

The FTSE All-Share continues to trade 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 near to stall-speed, the risks to the downside rise as the ability to contain systemic shocks falls.

The Brent oil price has fallen 3.3% over the past three months, and the gold price is down 4.5%.

Property was relatively resilient, putting in a positive return for the three month period, with the IPD UK All Property Index returning 1.2%.

Source: Cornelian Asset Managers November 2011

Investment Outlook

The US economy is currently surprising forecasters with its resilience. Indeed, consumer and business confidence survey results are more robust than expected and this is being reflected in the relative performance and valuation of the US stock market. It is undoubtedly true that the competitiveness of the US economy has improved, however it would be wrong to think the US is out of the woods.

Due to the rigidities built into the political system and the fact that Congress and the Senate are currently controlled by opposing political parties, tough decisions on fiscal austerity are being delayed. This cannot persist ad infinitum, although it is difficult to see how such difficult fiscal decisions can be taken before the Presidential election in November 2012, given the recent failure of the so-called 'Super Committee' to come to a negotiated settlement. Furthermore, housing is a significant driver of US economic activity and recently HSBC has warned that house prices may fall further as foreclosure activity increases following a hiatus in the process.

On this side of the Atlantic, the Eurozone has reached a precipice. Another false move and the economies of the member states could be seriously compromised. This is understood by policymakers and whilst we do not believe that the meeting of European leaders on 9 December will provide a definitive solution to the crisis, steps will be taken to foster better control over the fiscal budgets of member states.

With French (and Italian) Government Bond yields rising sharply, the credibility of the European Financial Stability Fund has been compromised and therefore it's ability to raise adequate funds has diminished. The European Union are, therefore, looking to the IMF to provide additional sums. Again, the quantum of what is available probably falls short of what is being demanded by market participants, but it may be enough to buy time. During this time it is expected that the Eurozone member states will formulate bilateral agreements to accommodate much closer fiscal integration. This, to our minds, will be exceptionally difficult to instigate. Will Italy (amongst others) be told it has to implement austerity until it meets the Maastricht criteria of 65% net debt/GDP? This could take 20 years! Will Ireland be told to double its corporate tax rate? Even if the political classes accept this, it is highly questionable that the electorates will. Furthermore, the French economy is at a critical juncture as growth slows and their ability to meet budget deficit targets is questioned, particularly given the potential need to inject capital into ailing French banks.

Logically, the only long term solution to the Eurozone crisis is the formulation of a United States of Europe, where there is a directly elected executive, tax rates are harmonised and transfer payments can be made across boundaries. This, of course, is as far away as ever. Indeed, President Sarkozy (no doubt with one eye on the forthcoming French Presidential election) has recently ruled out greater federalism.

With government, consumer and bank sector deleveraging the only game in town for the next couple of years (at least), an extended period of low growth, low interest rates and high unemployment is about as good as can be hoped for. This does not necessarily have to be bad news for equity markets and we certainly believe there are many good quality, highly cash generative businesses that can win out in such a scenario.

It is encouraging to note a piece of research from the Royal Bank of Scotland, which shows that the ten largest stocks in the UK (the so called 'mega caps') have, in the past when trading at similar cheap valuations as they are today, tended to generate significantly positive average annual returns going forward. Furthermore, on 2012 numbers they are forecast to generate a dividend yield twice that of the 10 year Gilt yield, despite exhibiting strong balance sheets and relatively conservative dividend payout ratios. In addition, the number of shares in issue for this group of companies has fallen by some 15% over the past ten years (due to share buybacks), whilst the amount of Government debt issued has grown substantially and is set to continue to do so for the foreseeable future. Without wanting to endorse every one of the UK mega cap stocks, I know where I would rather put my money.

We continue to favour Asian (inc Japan) equity markets both in terms of ability for policymakers to stimulate growth and valuation. We are intrigued by the valuation of the European markets, but remain content to sit on the sidelines for now, believing that further earnings downgrades will be forthcoming.

A low growth, low interest rate environment should ensure decent returns for holders of investment grade corporate debt.

Source: Cornelian Asset Managers – November 2011

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