MARKET OVERVIEW AND INVESTMENT OUTLOOK

AUGUST 2011

Market Overview

In local currency terms, the best mainstream asset class to be invested in over the three months to the end of August was UK Government Bonds (the FTSE British Government All Stocks returned 4.2%). Gilts were bought as the market veered sharply from the view that global growth was a little bit too warm and inflation risks were all around, to fears that growth is slowing and safe havens needed to be sought.

As the sensitivity to risk heightened, UK Corporate Bonds began to underperform Gilts (returning -1.3% (source: Citigroup) as spreads widened significantly.

Equity markets cracked in August as concrete evidence that global growth is slowing appreciably materialised, at a time when policymakers' hands appear tied on both sides of the Atlantic. This has been exacerbated by the very poorly timed announcement of the S&P downgrade of US debt to a AA rating, and heightened European sovereign debt concerns in Europe. The FTSE All-Share returned -9.4% over the three months to the end of August, marginally underperforming the FTSE World Index (£), which came in at -9.3%. In Sterling terms, European equities underperformed (-13.8%), whilst Japanese equities were relatively resilient returning -2.4%.

The timing of the S&P rating downgrade of US debt was most ill advised, following on from a particularly febrile week in the markets. Investors have now started to hunt for the next economy which might be downgraded from a AAA rating and have alighted upon France. Various indicators of stress in the French Bond markets have started to rise (relative to Germany) as a result, prompting President Sarkozy to announce further fiscal austerity measures.

Chancellor Merkel in Germany has appeared extraordinarily complacent in the face of the storm that has erupted in Europe. However, on reflection, we think she is following a clear path. It is apparent that Germany believes the only way to have a sustainable Eurozone is for real fiscal retrenchment and much closer economic integration and policing of budgets. For this to come about, a crisis is required.

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 9x and has a dividend yield of 3.7%. This dividend yield can be compared with the 10 year Gilt yield of 2.6%. The differential between the two figures is, in post war terms, exceptionally high. Other valuation measures comparing Gilts with UK equities suggest we are approaching similar levels to that seen in the previous equity market trough. This suggests that equities relative to gilts look exceptional value.

However, it should be noted that the trough P/E ratio during the systemic equity market crash of 2008/09 was some 30% 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 markets fall to close to stall speed, the risks to the downside rise as the ability to contain systemic shocks falls.

Oil prices fell a further 1.7% during the three month period to the end of August, whilst gold reacted positively to the enhanced uncertainty, rising 18.9%.

Property was relatively strong, putting in a positive return for the period, with the IPD UK All Property Index returning 0.7%.

Source: Cornelian Asset Managers August 2011

Investment Outlook

Previously, we felt equity markets could make progress during the second half of the year as many of the perceived threats to equity market performance seem to be dissipating as solutions to the European and US sovereign debt crises were about to be presented and the oil price had started to fall. Furthermore, the hiatus in the Japanese economy due to the earthquake and subsequent tsunami is about to come to an end. The second quarter results season was, on balance, somewhat disappointing but not materially enough to warrant the decline in equities that we have witnessed. The reason for the dramatic sell off in equity markets is that economic growth in the US and Europe is coming in much weaker than expected at a time when policymakers options to re-stimulate growth are severely hamstrung. This has magnified fears that Eurozone policymakers will be unable to contain the debt crisis engulfing their shores.

The potential for these fiscal moves to develop into a vicious cycle is real and has already been witnessed in the periphery, whereby enhanced fiscal austerity imposed upon already weak economies drives down growth still further, which due to lower tax receipts and higher unemployment widens budget deficits, which then requires further fiscal austerity. In such a scenario, international investors lose confidence in the country and outside help is sought. This is what has happened in Greece, Ireland and Portugal. The recent buying of Spanish and Italian Government bonds by the ECB is an explicit acknowledgement that these much larger economies are now in the same boat.

Germany will only come in behind Eurozone members, if the domestic politicians of member countries can deliver significant structural changes to how individual country economies are run. These changes would be negative for growth in the short term, but would enable a higher level of trend growth in the future. We believe the Germans see no point in propping up the system, until the much needed structural reforms are implemented, as this would only defer the crisis.

An initial assessment of the economic cost of breaking up the Euro suggests it would be significantly more costly to break up the Euro than keep it (source: Credit Suisse). There is considerable systemic risk here, and the Germans are playing a dangerous but, in our view, a necessary game if the Euro is to be saved. The scale and pace of the August equity market sell off has been so brutal that several indicators (which have been reliable in the past) strongly suggest that markets are oversold and a bounce is due. If this is to come about, it will probably be as a result of policy action and/or the fact that the economic growth slowdown will probably take longer to manifest itself than markets currently expect.

However, the concern lingers that policy makers do not have enough levers to pull to get decent levels of economic growth going again. However, there is quite a lot that can be done. Examples include a large, globally co-ordinated quantitative easing package, ECB rate cuts and the formation of a much larger European Financial Stability Fund. In addition, the US could announce explicit targets for 10yr and 30yr Treasury yields significantly below current levels, and Obama is gearing up to announce a sizeable plan to boost employment. The long term impact of these types of measures is keenly debated. Another positive catalyst could be the peaking of inflation in emerging markets, which would allow domestic policymakers to introduce further economic stimulus in these countries. It is significant that Brazil recently cut their main interest rate from 12.5% to 12.0%, this following a series of interest rate hikes. The true-ism that markets only stop panicking when policymakers start to panic feels apposite.

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.

Notwithstanding a possible short term bounce in more economically sensitive equities given how oversold they currently are, 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, multinational businesses with solid growth credentials will be valued more highly, and our portfolios increasing reflect this view.