

Thesis Market Commentary

February 2012

“And now for something completely different”

Monty Python

Current market behaviour reminds me of one of those typical British beach holidays of my youth, ie. every time the clouds clear and the sun comes out, everyone rapidly disrobes then it's on with the Nivea, knotted hanky and plastic flip-flops, followed by a kamikaze dash to the sea. The depth and duration of immersion was then directly correlated to the water temperature and - as this often varied between just about bearable to rigor mortis inducing - only the hardest of souls lasted more than a few minutes.

The last couple of months have witnessed a number of these sunny spells with both corporate and broad economic data from the US, UK, China and Germany generally slightly better than - albeit already watered down - forecasts. These acted as a catalyst, effectively dispelling some of the hangover of fear which dominated sentiment in the second half of last year. The injection of liquidity to the banking sector (particularly in Europe), the US Fed's commitment to loose monetary policy (no rate rises until 2014?) and growing expectations of a soft global economic landing have triggered a rise in confidence globally (although only on a shorter term basis for investment in the Eurozone) with equity markets (particularly Asian and Emerging), and their currencies, racing ahead, fuelled by the deployment of some of the accumulated cash reserves that have been burning holes in the pockets of institutional investors waiting for an opportunity to invest in risk assets.

How long will the rally last?

The consequent momentum-led rally over the last few months is following the same pattern as was last seen between August 2010 and February last year and consequently could have further to run. As I have mentioned in previous articles, fear can drive prices higher as well as lower - in this instance the fear of missing out on gains whilst also earning negligible rates on cash. Short term technical indicators (eg. volatility, momentum, directional and strength) all point to further short term upside, whilst - as mentioned earlier - the big guns amongst global investors are still holding significant liquidity and in current thin trading volumes only a small percentage of this needs to be committed to drive prices up.

Beware the Ides of March?

As Latin scholars will no doubt point out, the Ides is the 15th whereas D-Day (when the big loans fall due for repayment) for Greece is the 20th (well, actually the 27th to be precise as they have 7 days grace). The Greek problem therefore certainly hasn't gone away but there is now a resignation that default and exit would be better for the Euro, and the remaining Eurozone members, than the implications of an open ended bail out. The triggering of Credit Default Swaps would likely involve 'only' a net €5 billion hit on the financial sector which could now be accommodated relatively comfortably. The risk of wider contagion remains however but the liquidity pumped into the banking system via the LTFO (Long Term Financing Operation) has at least allayed fears of multiple 'Lehmans' and headed off, for now, the prospects of an imminent domino effect collapse in the weaker sovereign states.

Nevertheless, in due course we see a high possibility of further exits, ie. Portugal, Italy, Spain, Ireland and Cyprus, this on the assumption that the sheer scale of structural reforms that need to be implemented would be far more unpalatable than the alternative of restructuring debt, exiting the Eurozone, devaluing their own currencies and consequently returning to growth far more quickly. Despite the likely inflationary implications, there is plenty of precedent (eg. Asia and Latin America) to encourage this course.

Food for the bears (a tunnel at the end of the light?)

In even the most robust bull market one can always find reasons to be cautious. Outside of Eurozone worries, there are rising geopolitical tensions concerning Asia and the Middle East, the Iranian nuclear situation, fundamental political changes in China and - thanks to the combination of low wages growth, inflation and high unemployment in developed market economies - increasing signs of a slowdown in consumer spending and saving. On top of this bank lending remains severely constrained.

This Month

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These are all good reasons to head for the hills but here are a few key reasons not to:

- Share prices generally have been lagging actual earnings growth for many years
- Participation in the rally has so far been low and very selective (as compared with the high volume indiscriminate selling last summer)
- Equities yield significantly more than cash and government bonds
- Whilst there will be further casualties, in a tough environment quality stocks with earnings growth will command a high premium
- QE may be extended to the corporate sector - probably subordinated debt of weaker key employers and smaller/medium sized companies
- Markets are already discounting much of the slowdown and potential event risks - and in the case of the latter not all of these may actually happen.

So is it time to throw caution to the wind, cast off those gilt-edged corsets and follow the 'risk on' swimmers into the sea of tranquillity, or should one remain firmly wrapped up on the beach waiting to see if a rogue wave or passing shark engorges the more adventurous swimmers? I would suggest a compromise, ie. roll up your trousers and have a paddle, it may be warmer than you think... but keep an eye out for those clouds.



Michael Lally
Investment Manager

Email Michael with any feedback:
michael.lally@thesis-plc.com

"So goes January, so goes the year..."

So the old saying goes and as I said exactly this time last year after the market's fall of 0.63%, "If the above saying proves correct, the market is unlikely to move very far at all". With hindsight how apt this was and in fact it retreated downwards a fair bit more. However, what of 2012 in relation to this past trend, now that we have seen a rise of 1.96% since December?

Trying to find positive forecasts in the current environment is like trying to find a needle in a haystack. They do exist but they are certainly not easy to find! Interestingly, we keep seeing three forecasts from various economists, based on possible outcomes of the Eurozone's critical condition - 1. 'Status Quo' position maintained (nothing much changes really), 2. 'Minor Hiccup' (a member or two leaves) and 3. 'Total Fallout' (Euro implosion). With these useful predictions I was reassured that none of us really know! However, I did come across an interesting piece entitled "Inconvenient facts for the Bears" which outlined eight facts on why there are reasons to be positive about equities:

Comparative Index performance ▼

Indices	Value as at 31/01/12	% Change on Month	% Change on 12 Months
FTSE 100 Share	5681.61	1.96%	-3.09%
FTSE All Share	2932.91	2.63%	-3.66%
Dow Jones	12632.91	3.40%	6.23%
Euro Stoxx 50 EUR	2416.66	4.32%	-18.18%
Nikkei 225	8802.51	4.11%	-14.02%
FTSE A British Government All Stocks	174.10	0.31%	13.54%
Sterling/US\$	1.5760	1.40%	-1.59%
Sterling/Euro	1.2045	0.48%	3.00%

- Earnings are growing, and in most markets faster than average
- Corporate debt is low and trending lower
- PE ratios are near 15-year lows
- PEG ratios are (mostly) reasonable (a measure of growth and value)
- Equity dividend yields are well above 15-year average
- Equity dividend yields are well above bond yields
- Equities provide a partial hedge against inflation - bonds generally don't
- Price to book ratios are near 10 year lows

Ever the optimist and a realist that markets will always do what you least expect, I thought this was worth sharing. In eleven months we will know the answer...

Market News

Corporate earnings for the S&P 500 constituents as a whole are set to break a run of eight consecutive quarters of double-digit gains, with expectations of average earnings growth in the fourth quarter of 2011 standing at 7.2% over the same quarter in 2010.

The US economy created 243,000 jobs in January, while the unemployment rate fell to 8.3%.

Deloitte has said 42 retailers in England and Wales called in administrators in the final quarter of 2011, a 27% rise on the 33 failures in the previous three months.

China leapfrogged the US to become the biggest buyer of Rolls-Royce cars for the first time in the group's 107-year history, as sales to the country soared by 67% to more than 1,000.

Net retail sales of funds slumped nearly 40% last year to their lowest level in three years, according to the Investment Management Association's (IMA) figures for 2011. Equities were the most affected, with the asset class pulling in just £3 billion - less than half the sales of £6.9 billion it saw in 2010. However, this data often serves as a contrary indicator to future market direction...

Resources

Xstrata and **Glencore** are in talks over an all-share merger that could create a combined group worth more than \$80 billion, shaking up the industry with its biggest deal to date.

China's gold output rose again in 2011 confirming its position as the global No. 1 producer.

British MPs are to question UK oil and gas companies - **BP**, **Shell** and **Cairn Energy** - on the safety of drilling in the Arctic, after fears that retreating ice will see a damaging rush to exploit billions of barrels of untapped reserves in the region.

Financials

Deutsche Bank, the largest German bank, reported that its net profit plunged in the fourth quarter after the European sovereign debt crisis and turmoil in financial markets led to a loss in the investment banking division. **Banco Santander** announced that quarterly earnings fell nearly 98% to €47 million, as it dealt with the downturn.

Bank of Georgia, the biggest bank in the former Soviet state of Georgia, is on track to join the FTSE 250 index under plans to incorporate the business in London.

The Chairman of 82% taxpayer-owned RBS said bankers' pay has been "high for too long" and needs to be corrected - Doh!

Property

The amount of money investors spent on commercial property in central London rose 10% last year to £10.9 billion as the Eurozone debt crisis turned the West End and City into a safe haven.

Retail

Tesco suffered its worst Christmas in decades after a massive slide in sales over the period.

The **Benetton** family plans to delist the Italian fashion chain that bears its name by buying the shares it does not already own, as retailers across Europe struggle.

Ladbrokes has started talks with Irish billionaire Dermot Desmond, the owner of the **Betdaq** betting exchange, over a 'technology' deal to revamp the bookmaker's faltering online business.

Tech & Telcos

Facebook is set to be the biggest IPO of the year with a potential market value of between \$75 and \$100 billion. Founder Mark Zuckerberg will still retain the majority of voting rights.

BT reported a rise in profits, thanks to cost-cutting and an increase in broadband users.

Pre-tax profits for the three months to the end of December were 48% higher than a year earlier.

Nokia has lined up a new Chairman, as it continues to turn the business around. Japanese electronics giant **Panasonic** has forecast a record annual net loss of 780 billion yen. The poor result is being put down to the strong yen, flooding in Thailand and acquisition costs. It comes after rivals **Sony** and **Sharp** also predicted losses.

Finally, the performance of the Mei Moses All Art index, a leading barometer of art returns based mainly on paintings sold in New York and London, beat the total return of the S&P 500 index of US equities by about 9% over 2011.

Sources: *Unique Boutiques Conferences - Cavendish AM Dealbook, Yahoo Finance, Minweb, BBC News, Reuters, Citywire and Investment Week.*



Giles Marriage
Investment Manager

Email Giles with any feedback:
giles.marriage@thesis-plc.com

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