



## The strategist: reaping value from recovery

By Michael Lally | 00:01:00 | 29 July 2009

### **Be flexible to make the most of stock market momentum, says Michael Lally, director of Thesis Asset Management.**

The recent case of the insomniac oil trader at PVM, who lost the company £6 million as a result of a reckless speculation in London Brent crude oil, is not the first such scandal to make the headlines. But it does highlight the ease and speed with which traders can influence the price of any financial asset. For aficionados of Keynes, back in 1936 he wrote that 'Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation.'

Without doubt the activities of such traders, both individually, but more often as a collective force, do influence prices. Not always to the degree that the media would have us think, but certainly sufficient to make the job of asset managers more difficult. In terms of share markets, we saw earlier this year how short selling almost destroyed some companies and in others either deferred or made more costly their capital raising plans.

#### Reading the road ahead

So, notwithstanding such distractions, how are markets likely to progress from here? There are undoubtedly some green shoots; in the UK as evidenced by small rises in the Nationwide index of house prices, in manufacturing output and in the manufacturing Purchasing Managers' index (PMI). With the banks still more concerned with protecting their fragile balance sheets than resuming lending, we can expect the Bank of England, over the next few months, to announce a further extension of its quantitative easing programme. Falls in retail sales figures, combined with levelling off of mortgage lending and higher unemployment figures, mean there is little prospect 'of the Lady turning' when a general election is now firmly on the horizon. Overseas, more optimistic corporate sentiment surveys in the US and Europe, and China's first major fiscal stimulus package, have been sufficient to underpin share markets.

#### Resurgent equities

Big investors have been dipping their toes in the water, notably in equity and corporate bond markets, but it's still a bit too chilly for total immersion. However, the pressure to reduce their overweight cash and government bond holdings will increase and when it becomes clearer that the yawning gap between equity yields and deposit rates won't be narrowed as a result of interest rate rises then, probably later this year, this is likely to facilitate a further significant upward revaluation of prices. This is not necessarily to be viewed as the start of a major bull market, merely another common sense reality check. But, as the chart of previous bull markets shows, when the momentum rally does begin it's extremely difficult to catch up if you're left behind.

As the origins of the bear market lie in credit markets then this is where to look first for signs of a return of confidence. Heavily oversold corporate bond markets

have rallied this year, but as with the equity markets, rises have been very selective apart from a brief bounce at the toxic end (a 'dash for trash'). Top named global companies, like Unilever and Vodafone, have recently successfully issued billions of pounds of debt at around half the premium to gilts that would have been the case at the turn of the year.

#### Raising exposure to commodities

With a little more economic stability now on the horizon, and having monitored commodity markets closely for the last year or so, we have now initiated a modest stake in clients' portfolios (albeit at this stage only via a long/short fund covering both metals and soft/agricultural commodities). Prices can be influenced by a wide range of factors (lots of 'black swans') but much of the speculative excesses have been unwound since last year which makes it a little easier to see the wood from the trees.

The unique nature of this recession suggests that it will pay to be flexible, and that investors should not risk adhering too rigidly to the old mantra of 'a long-term lock away' – unless of course your name happens to be Bernard Madoff!

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