

APP  
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# the View

A Thesis Asset Management view of the market



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Clearly different. Uniquely rewarding.

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## OurView



Michael Lally

***'We are placing the burden on the broadest shoulders. I made up my mind that, in forming the Budget, no cupboard should be barer, no lot should be harder to bear.'***

**Lloyd George (People's Budget speech 1909)**

As Gordon Brown bathes in the plaudits for coordinating an unprecedented global rescue package by the G20 leaders, and markets rebound (Wall Street recording the fourth largest rise in history and biggest rally since 1938) suddenly the light at the end of the tunnel appears a little brighter. "I would say that it is probably the first time that the authorities are actually ahead of the curve" said billionaire investment guru George Soros. So, panic over, roll on the next bull market then. Well, not quite.

The figures are undoubtedly staggering, but perhaps not quite as great as the politicians would have us believe. After all, politicians do have an innate talent for 'smoke and mirrors' when it comes to explaining or justifying fiscal expenditure. For example, as far as the \$5trillion package is concerned:

- the figure includes all borrowings already accumulated since 2008 (and forecast through to end 2010)
- much of this represents recouping lost tax revenues together with higher welfare spending - a normal result of any recession - aka 'automatic stabilisers'
- the IMF estimates the actual amount of new discretionary spending as \$780billion this year and \$590billion in 2010.

The headline grabbing number is the \$1.1trillion to restore 'credit, growth and jobs'. Let's see how this breaks down:

- \$500billion to the IMF. Half of this was already pledged (Japan's \$100billion last November), the rest is left open as to timing and individual amounts
- \$100billion for international development banks. This will be spread over 3 years
- \$250billion of Special Drawing Rights (SDRs). Will it just sit in the IMF accounts? Only \$100billion will be available to poorer and developing countries as richer countries enjoy the lion's share of quotas

- \$250billion for increasing trade finance. Most will come from the private sector; just \$3-4billion has been specifically pledged (via a World Bank scheme).

The question for markets is whether the rises over the last few weeks are sustainable or merely another bear market rally. The answer, of course, is that it is still too early to say. It all depends on investors' time horizons. Whilst, as I have said before, markets discount economic recoveries well before they actually begin, the lead-in period is rarely less than 12 months. The acid test is how well investors weather the further bad news this year, eg. profits for US stocks are expected to fall by around one third in the first half of this year, unemployment globally will continue to rise sharply and bad debts increase. More rights issues and dividend cuts will also test investors' nerves. In addition poor liquidity in many asset classes means that there is still probably a long queue of stale or distressed sellers.

On a positive note inventories are much lower than demand and there are signs of this cycle improving. The US Geithner plan (which triggered the big rise in financials stocks) gives banks the opportunity to clean up their balance sheets and offload some of that toxic debt - if they are prepared to sell and face the consequences. Corporate bond markets appear to have stabilised and spreads tightened, which is an essential prerequisite to restoring confidence to credit markets generally. The housing market is expected to bottom out later this year. In the US, if the Fed's quantitative easing programme facilitated a reduction in 30year fixed rate mortgages from the current 5% level to, say 4%, I believe this would be an important trigger in terms of consumer confidence/and spending.

Whilst, therefore, we welcome the recovery in markets and (net) benefits of the G20 initiatives, we are not yet increasing equity exposure in portfolios, at least until we are convinced that risk appetite has returned to a degree sufficient to accelerate the reduction in the toxic debt mountain.

Meanwhile whilst the media has focused on the G20 talks, closer to home the collapse of the Dunfermline Building Society merited relatively brief attention, and following on from the dramatic fall from grace of the Royal Bank of Scotland, this must surely now put paid to the common perception that the Scottish are careful with money!

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## News



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### Markets

Indices	Value as at 31/03/09	% change on month	% change 2009 year to date	% change on 12 months
FTSE 100 Share	3926.14	2.51%	-11.46%	-31.15%
FTSE All Share	1984.17	2.82%	-10.19%	-32.21%
Dow Jones	7608.92	7.73%	-13.30%	-37.95%
DJ Euro Stoxx 50 Đ	2071.13	4.80%	-15.52%	-42.91%
Nikkei 225	8109.53	7.15%	-8.47%	-35.26%
FTSE A British Government All Stocks	157.83	2.43%	-1.87%	5.18%

Clearly March was an unusual month with positive returns coming from the majority of major markets and UK Gilts. What remains to be seen is whether this upwards momentum can be maintained in April. Of virtual certainty is that the G20 Summit's PR machine will not cease until positivity rains - too many politicians' lives are at stake!

March will be remembered for a string of rights issues, Segro, Land Securities, British Land, HSBC and Xstrata. What they all have in common, least of all weak but now slightly stronger balance sheets, is they all previously enjoyed meteoric rises ahead of the dawn of the credit crunch and global economic meltdown (with the exception of HSBC). Amazingly these rights issues are being taken up by institutions, which according to some sources are continuing to sit on fair amounts of cash, thus in effect partly reversing the 'de-listing' process of the last decade, where private equity bids and share buy backs were all the rage. So are these measures the last stitches in the wound or can we expect further gashes? At this stage, it is perhaps too early to call the bottom, but there is certainly plenty of blood on the streets, not least outside the Bank of England and Royal Bank of Scotland's offices...

At Thesis we are focusing our efforts on seeking out companies with low gearing (borrowings), high cash weightings and rising dividends... yes I did say rising, although from media coverage you may be surprised to learn that more companies are maintaining or actually increasing dividends than are cutting them. Another area of focus is the large 'Blue Chips' who are able to cut

costs and also have pricing power (via high barriers to entry) - utilities and BskyB spring to mind. From a sector perspective there is much talk of infrastructure spending to boost the economy (perhaps the London Olympics is beneficially timely) and we continue to like this area, as well as those companies that will benefit from emerging market growth. Clearly Asia and Latin America are not immune from a slowdown in the West, but there can be no doubting that industrial revolution in these parts of the world looks set to continue even if they do take a breather for a while. In essence, with the UK market yielding 5.1% one can hopefully afford to be patient so long as you are invested in the right areas.

### News

**Carillion** produced some good results at the beginning of last month, demonstrating the case for infrastructure and support services in the current environment, where firms seeking to cut costs look to outsource more. Profits were up 55% and the company has an excellent order book of £20.4billion. Over the period they realised 23 investments and although they are seeing a significant slowdown in Dubai, this is being offset by growth in other parts of the Middle East. The shares trade on a Price Earnings Ratio (PER) of 6x, delivering earnings growth of 10% and are yielding over 5%.

Consultancy group **RPS** also demonstrated very resilient results with profits rising by 28%. The group witnessed growth in a number of divisions: energy, health and

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## News



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safety and environmental, although unsurprisingly reported a weaker outlook in planning and development. The shares also trade on a PER of 6x, yet continue to produce excellent growth prospects.

**Arriva's** full year results were slightly ahead of consensus forecasts. Revenues were up 55.1% after a transformational year with expansion in Europe and the cross country franchise in UK Rail. Earnings per share increased +27.1% and the dividend was raised by 6.2%.

**Royal Bank of Scotland**, everyone's favourite bank of the moment, unveiled the biggest ever corporate loss in UK history (£24billion). Much of the loss was due to the write down of ABN Amro. The bank will be participating in the Asset Protection Scheme - placing £325billion of assets under Government protection. The cost paid in shares will potentially see it become 95% nationalised.

**Lloyds (HBOS)** also announced a big pre-tax loss. Tier 1 ratio is around 6% (core capital), but this is flattered by around one third by 'fair value' accounting of HBOS' own debt. The stock price has also been volatile, although generally bank shares have had quite a good month. Lloyds also said that 30% of HBOS's loan book would have been rejected by them under its loan criteria.

**Barclays** has reported that it is in discussions with a number of potentially interested parties about the sale of **iShares**, which is part of its Barclays Global Investors (BGI) division. The private equity house **CVC** looks to be in the front running. Elsewhere, **HSBC** has dismissed any need to participate in the Asset Protection Scheme.

**Marks & Spencer's** fourth quarter earnings beat expectations. The group maintained market share in clothing, "noting good performances in kids and lingerie and weaker performances in larger women and menswear categories". Food sales demonstrated an improving trend, due to more competitive pricing and effective promotional activity.

**Royal Dutch Shell** updated investors on strategy. The group is maintaining its long term perspective but is looking to reduce costs, planning on the downturn lasting more than a year. However, the fundamentals for energy demand remain positive and investment in 2009 will be in the region of \$31-\$32billion.

**BG Group** announced that its wholly-owned subsidiary, BG International (AUS) Pty Limited, now has a relevant interest in 96.68% of the ordinary share capital of **Pure Energy Resources Limited** under its recommended A\$8.25 takeover offer. BG Group will now proceed to compulsory acquisition of all the remaining Pure Energy shares.

**Premier Oil** has announced a 4:9 Rights Issue at 485p per share to raise £171million. They are acquiring **Oilexco North Sea Ltd** for \$505million to be funded from cash and credit facilities, but leaving the group with \$385million at completion for the current year's drilling activities. At first glance this looks a complementary purchase geographically, as it increases scale and will give Premier immediate additional production.

Following financing problems with its parent company down under, **Babcock & Brown Public Partnership (BBPP)** is to be acquired by Amber Infrastructure Group, a new independent company. Amber will acquire the rights to the advisory and management services to BBPP, previously supplied by Babcock & Brown Investment Management Limited. The existing management team will transfer to the new entity.

The **Tiscali** story has moved on again. Following the breakup of talks with **BSkyB**, reports now suggest it is in talks with **Carphone Warehouse** to sell its UK broadband arm. It is no surprise that the stories have reappeared, since the price now looks sensible. For a start, the share price has fallen by 75% since the BSKyB talks, when Tiscali was trading around €1.5 a share.

Norwich Union Life, the UK life insurance business of **Aviva**, has said it will cut around 1,100 jobs in the UK this year to help make its operations more efficient. The announcement comes after Aviva Chief Executive Andrew Moss last month warned about the job cuts, which could signal a new round of job losses across the insurance industry. **Friends Provident** also recently warned about possible staff cuts, while **Old Mutual** has said it will streamline operations and sell businesses. In a statement, Norwich Union, which will soon be rebranded as **Aviva**, said "there is expected to be a reduction of 1,100 permanent roles by the end of 2009, though the impact on staff will be minimised by natural turnover and redeployment."

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