

FEB
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the View

A Thesis Asset Management view of the market



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OurView



Michael Lally

'History teaches us that men and nations behave wisely once they have exhausted all other alternatives.'

Abba Eban

With the 'annus horribilis' of 2008 behind us we have started this year with a conspicuous lack of optimism - not entirely surprising given the challenges ahead of us. In fact market movements and economic announcements remind me of the film Groundhog Day, stuck in a time warp where immediate history constantly repeats itself.

At least this time we can't accuse governments of not being proactive. With the banks having failed to sell (or avoided valuing) their toxic bonds (did they try eBay?), then HMG, following the Fed's example, will now step in as buyer of last resort. But this time the banks may have to buy short dated gilts or government backed bonds rather than pocket the cash. The economists call this strategy quantitative easing, which sounds like a remedy for constipation, and in financial terms, there is a strong similarity given the cutback in bank lending; in reality it is just a more complicated alternative to just printing money.

Will it work? In the US, the average fixed rate mortgage life is 30 years as opposed to just 3-5 years in the UK. Hence the Fed's policies have enabled borrowing rates to drop below 5% (average 6% last year) whilst yields on 30 year Treasury bonds have dropped by 2%. In the UK Mr Darling is still pondering his options and it is more likely we will see a mixture of insurance backed schemes as well as full scale purchases of toxic debt.

The main difference between the last credit crisis, ie the US Savings and Loans (SLAs) debacle in 1989 and now, is that the vehicle used by the US government then, the Resolution Trust Corporation (RTC), only stepped in after the SLAs became insolvent. This time shareholders are being given a lifeline. Part of the reason for this is wholesale purchases of bad debt could force many banks to crystallise the full extent of losses, and potentially trigger more insolvencies.

Concerns last month as to the deterioration of the UK's public finances and ability to service foreign currency denominated debt, particularly if the government is forced to nationalise some or all of the major banks, led to a brief run on the pound (down 11% against the dollar in one week - but since up nearly 7%). The level of near panic is best exemplified by the cost of credit default spreads (CDS), effectively an insurance against bond default. Recently it was cheaper to insure a 'Big Mac' (MacDonalds) bond than a gilt!

But isn't everyone else in a similarly dire position? In Europe never mind the problems of the Portugal, Ireland, Greece and Spain latest figures from Germany highlight their deteriorating position, and we believe the euro could be this year's poor relation. It is interesting that last months 6% drop in the pound against the euro has since been turned into a 7% rise. Admittedly, given the poor liquidity in many other asset classes currently, currencies and government bonds offer the big speculators, such as hedge funds and pension funds, a golden opportunity for profitable trading - hence recent movements may be somewhat exaggerated.

There is some good news however. Apart from the easing of mortgage lending rates the gap between central bank rates and money market rates is narrowing (a key indicator I mentioned last year), as has the yield premium on both investment grade and junk bonds over treasury bonds (albeit the former distorted by the effect of government guarantees on some bank debt, which constitute the greater majority of the bond indices). A weak sterling highlights the attraction of UK assets, and benefits exporters at a time when global deflation minimises the inflationary aspect of imports.

The success or otherwise of current initiatives, to restore confidence in counterparties and stimulate lending, is crucial in determining whether the global economies experience merely an extended period of recession (the most likely outcome) or a full blown depression.

It will take many months before the picture is clearer, during which time conflicting indicators can be expected to cause more volatility - but also opportunities. To successfully negotiate these turbulent waters, we believe, will necessitate more aggressive trading strategies - ie not a year for donning tin hats and rubber pants and doing nothing.

Last week Paul Polman, the new CEO of Unilever, upset markets, when announcing 4th quarter figures, by refusing to make specific forecasts for 2009 because of the many uncertainties and variables. In many respects a sensible move, but markets live off forecasts - however unstable and subject to subsequent revision - hence the initial 6% fall in the share price. As Eugene Ionescu said 50 years ago (in *Le Rhinoceros*) "You can only predict things after they have happened." The current round of profit warnings, revisions and cost cutting measures in the corporate sector will continue at least for the next few months, by which time markets should be discounting the worst. Then we can make better informed forecasts.



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News



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Markets

Indices	Value as at 31/01/09	% change on month	% change 2009 year to date	% change on 12 months
FTSE 100 Share	4149.64	-6.42%	-6.42%	-29.43%
FTSE All Share	2078.92	-5.90%	-5.90%	-30.70%
Dow Jones	8000.86	-8.84%	-8.84%	-36.75%
DJ Euro Stoxx 50 E	2236.98	-8.75%	-8.75%	-41.02%
Nikkei 225	7994.05	-9.77%	-9.77%	-41.19%
FTSE A British Government All Stocks	153.53	-4.54%	-4.54%	2.18%

Whilst a considerable amount of time has been spent over the last year advising clients in respect of bank deposit accounts, incredibly the last few weeks have been spent discussing bank shares, where private investors of all shapes and sizes have been seeking to get involved. According to a leading online broker, private investors' dealings in bank shares accounted for 83% of all transactions in late January. Oh, how things can change so quickly!!

The market's gains in late December were wiped out in early January as investors took further fright on the banks. Amazingly the sector now only accounts for about 9% of the FTSE 100, from its previous 25%. Rather ironically it was the Government's announcement in respect of its 'insurance scheme' proposals that really spooked investors and led to talk of further nationalisations, whilst the aim was actually to boost lending to UK companies, not to prop up the banks share prices! As is often the case, the devil is in the detail, which won't really be known until probably the end of February, by which time we will have had further announcements and witnessed a number of results.

In a nutshell, the insurance scheme will partly guarantee the so called 'toxic assets' on bank balance sheets, whilst the Bank of England announced a £50bn asset purchasing scheme, which is in effect a form of 'quantitative easing'. Not so prominent, but equally important, was that the FSA clarified its position on capital ratios and is happy to see reserves being reduced during the downturn. These measures are likely to take time to become effective, but in the meantime, we have seen part nationalisation in the US, full nationalisation of **Anglo-Irish**, record profits warning from **Deutsche Bank** and increased state ownership of **Royal Bank of Scotland**.

It is often during unsettling times that new emergent's thrive and prosper and one such potential company is **Zopa** - as they say on their website 'Social Lending is where people lend and borrow money with each other, sidestepping the banks. And the more you think about it, the more it makes sense...'. Worth a look at <http://uk.zopa.com/ZopaWeb>

Stock News

Barclays open letter towards the end of the month was the talk of the City and has helped turn around the sector from demise recently. The company confirmed that they will not turn to the Government or private investors for emergency support, claiming they do not need any more cash. Following speculation about Barclays' possible exposure to bad loans, the bank has revealed just £8bn of write downs relating to the credit market at Barclays Capital - roughly similar to the £9.7bn exposure revealed by **Royal Bank of Scotland**.

The letter, addressed to employees, customers, clients, and shareholders, points out that the bank has £36bn of equity capital and its profits-before tax for last year are expected to be ahead of expectations 'after all costs, impairment and market valuation adjustments'. And results in today show profits of £6.08bn before tax.

Glaxo's fourth-quarter sales rose 16% to £6.9bn, flattered by a weak pound and the company is slashing costs and jobs in a new round of restructuring which shows the pressures building on big drugmakers as cheap generics eat into sales. But the world's second biggest drug company said it had no intention of following market leader **Pfizer** in embarking on a new phase of mega-mergers.

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News



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In a surprise move (which now everyone seems to be doing!), Glaxo also said it had decided not to give specific guidance on earnings for 2009. The company said the decision was not connected to performance and was designed to focus investor attention on its long-term goals. **AstraZeneca** has also announced 6,000 job cuts and Pfizer, which has agreed to buy **Wyeth**, plans to cut 15% of the combined workforce, or about 19,000 jobs.

Vodafone beat market expectations, their figures were up 14% on a like-for-like basis thanks partly to a weaker £Sterling. The figures were around 3% higher than the previous period. The company's revised guidance doesn't allow for Verizon buying Alcatel which will add around 6% to earnings per share. Verizon (US) is reportedly performing well and satisfactory performance in Europe was encouraging, where there were also positive comments in respect of **BlackBerry** handset take-ups.

BSkyB's shares rallied after they announced that four of six live Premier League packages have been secured. There is very little detail about what packages have been secured and at what price. Inflationary pressures are likely to have eased as **Setanta** and **ITV** are unlikely to be able to finance blockbusting bids. With two packages left it is rumoured that Sky may try for a fifth, the most available under EU regulations. Full details are only likely to emerge once the bidding process is completed for all six packages.

BT traded lower after announcing a profit warning on its Global Services division. This is likely to impact the dividend. The market disliked the lack of clarity and that BT had not been upfront. Further disappointment is likely in the short term.

BG Group produced another record set of figures with earnings growth for the quarter +26% and +74% for the full year and grew its reserves by 31%. In our view the company remains 'best in class' - with strong financials and a positive outlook.

Royal Dutch Shell's fourth quarter results were mixed, but much as the market expected were at the operating level given the fall in the price of crude. On an annual basis Shell has posted a 14% rise in profits to a record \$31.4bn. A full strategy update is due on 17 March. Fundamentally the shares look attractive longer term - healthy growing dividend and on an undemanding rating, but it is still playing catch-up in the reserves stakes and dependent on some mega-projects to underpin future earnings.

Like Shell the latest figures from **BP** were mixed. They were good for the year but disappointingly at the bottom end of consensus for the last quarter - mainly a reflection of the fall in the oil price too. However, operationally the company is showing improvement and the dividend is both secure and supportive to the share price.

For the sector overall the story remains compelling and share prices at these lower levels represent good value for the longer term investor. New finds are not sufficient to replace current demand so there will inevitably be a rebound and OPEC has made it clear the average price that is needed per barrel to ensure long term supplies is US\$75 - especially from non-OPEC countries and to encourage exploration in difficult areas. 2009 is being regarded as the 'trough year' for the current oil price cycle. Research from Cazenove shows that the International and National oil companies expect to increase spending by 11% in 2009 - whereas the independents/smaller explorers indicate a 25% decrease.

AMEC remained upbeat on its trading prospects despite the background of falling energy prices and the effect this may have on energy company capital expenditure. Pre-tax profits for 2008 are expected to exceed £200m and year-end cash should be in excess of £750m - possibly leading to bolt on acquisitions. **Premier Oil** also had an update reaffirming average production for 2008 and remaining on target for future production to the end of 2010.

A trading update by **Johnson Matthey** was well received with a price rise of some 6% on the day. Although the forecast indication of earnings was lower than last November (the time of the last set of results) there were good points in the statement. The main one was the robust performance of the platinum price, which is up 12% in US\$ terms and 23% in £Sterling terms, despite weak automotive demand. The latter is having a negative effect on catalysts and this is likely to worsen steadily during 2009; however, this is probably now in the price and the market will look to 2010 which will see new emissions legislation and hopefully, stabilisation of the auto industry.

General retail stocks and food retailers had a better than feared festive reporting season. Positive broker notes were issued on **Sainsbury's** and **Kingfisher** following the sale of its French Castorama business. Stronger than expected trading at **JD Sports**, which reported positive like-for-like sales, also led to upgrades.

All in all, the reporting season has not got off to a bad start and recent trading updates, whilst obviously being cautionary on the future, do not paint as bleak a picture as many would have you believe... Lastly and on a similar vein, the FT has reported that the Baltic Dry Index has surged by over 50% the last week (to 5 Feb). The Index is the benchmark for freight costs for dry bulk commodities such as iron ore, coal and grains - and as such a measure of health on the global economy.

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