

OurView



Michael Lally

"The rule is, jam tomorrow and jam yesterday - but never jam today."

The White Queen - Through the Looking-Glass (Lewis Carroll).

With global equity markets having generated returns in sterling of around 50% over the last year, and high yield corporate bonds nearly double that, it is perhaps not surprising that many pundits are encouraging investors to run for cover. Let's face it, the words "budget deficits" and "hung parliament" are sufficient to send shivers of uncertainty through even the most seasoned investors.

This would therefore seem to be a good time to reflect on how markets have actually performed over the credit crisis.

Index	1yr	3yrs
FTSE All-share	+46%	-11%
S&P 500	+39%	-19%
FTSE Europe ex-UK	+43%	-28%
Japan	+27%	-36%
FTSE All-Emerging (large cap)	+80%	+11%
IBOXX (Corp bonds)	+10%	+14%
IBOXX (Corp High Yield)	+85%	+20%

The lesson for last year was clearly to run with the winners, ie. emerging markets, high yield corporates, distressed financials and - to a lesser extent - commodities and miners. In the February edition of TheView I forecast that, despite previous gains, markets could move around a further 5% higher over the following month or two. In fact the FTSE World index gained 7% (and FTSE All-share 9%) by the end of March.

Momentum in markets doesn't necessarily always imply an inflating bubble, but where liquidity is tight then valuations can get ahead of themselves. Where the asset is part of a major index then this overvaluation can run for quite some time, underpinned primarily by the key distressed buyers, ie. tracker funds. Of course when the asset drops out of an index (or, in the case of corporate bonds, have their credit rating downgraded) the reverse is true.

Nowadays the picture is blurred by the actions of derivative markets and hedge funds. Credit default swaps,

for example, are now probably a more avidly monitored indicator of corporate (not to mention sovereign!) financial health than P/E ratios or cash flow data.

Turning back to the performances of the market indices we now believe that, with some of the distortions of the last two quarters' data now largely behind us, we are heading for some form of reality check. The main reasons for this are:

- Despite the government induced profits in the banking sector, their balance sheets are still very fragile and lending to the corporate sector is way below the levels needed to maintain the recovery. Some clever balance sheet re-engineering has generally been welcomed by markets (not surprising given the alternative!) as has the fact that in future they will have a legal obligation to maintain stronger balance sheets - which is far more important
- The Greek rescue package is like fixing a broken fan belt with your wife's tights - it may well get you home, but before long a more substantial repair will be inevitable. And for those with Spanish, Italian or French cars I'd recommend keeping some spare 100 denier tights in the boot - try IMF on-line!
- The spectre of rising unemployment, coupled with government cutbacks, will impact further on consumer spending as well as both central and local government
- Some high yield bond yields are too low
- Further dividend cuts and rights issues can still be expected.

Because the current climate is, as we have said before, conducive to more bid activity, and interest rates are likely to remain low for some time, then the extent of any retrenchment is unlikely to be significant - barring over-enthusiastic negative momentum.

At an asset allocation level we have reduced our exposure to UK large cap equities (pre-election jitters and post election sterling recovery) and increased investment in hedge funds (beneficiaries of volatility, further share buy backs/tenders, further narrowing of discounts and increased confidence as a result of greater transparency). However we are, for now, maintaining our biggest overweight positions, in emerging markets equities and bonds, as the economic fundamentals remain benign.

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Markets

Indices	Value as at 31/03/10	% Change on Month	% Change 2010 year to date	% Change on 12 Months
FTSE 100 Share	5679.64	6.07%	4.93%	44.66%
FTSE All Share	2910.19	6.34%	5.41%	46.67%
Dow Jones	10856.63	5.15%	4.11%	42.68%
DJ Euro Stoxx 50 €	2931.16	7.43%	-1.18%	41.52%
Nikkei 225	11089.94	9.52%	5.15%	36.75%
FTSE A British Government All Stocks	152.02	0.76%	-0.07%	-3.68%

Election fever?

As another good month for markets passes, clients are frequently asking what effect the election result may have on the UK stockmarket. With the media in full swing and now a confirmed date of 6 May, Channel 4's programme "Meet the Chancellors" has finally got the show on the road - personally I could hardly contain my excitement. What's clear is that whilst Sterling and Gilts seem to be under continuing pressure whenever an opinion poll indicates a hung parliament, the same cannot be said for the equity market. There are some good reasons for the UK equity markets to be comparatively sanguine, in that the FTSE 100 is simply no longer a barometer on the health of the UK. With so many overseas companies listed on the Exchange and so many leading UK companies being internationally diverse (60% of the FTSE 100's sales are from outside the UK); the election result is unlikely to have so much impact on UK multinationals. Certainly, one should expect either a relief rally or a sell off on the day of the result, but thereafter, we would expect that the UK market will continue to track the fortunes of its international peers.

On the economic front, the latest annual Consumer Price Inflation (CPI) fell to 3% in February, from January's 14-month high of 3.5%. With inflation heading back to target, the Bank of England will be in no rush to raise interest rates. Similarly, the US Federal Reserve has indicated that interest rates will remain low for an "extended period". Elsewhere, fourth quarter UK GDP figures were revised up to 0.4% (from 0.3%).

We have officially moved from a Greek tragedy to a surreal comedy... with Prime Minister George Papandreou blaming speculators who bought contracts on Greek bonds they didn't own, so-called 'naked swaps', for worsening the nation's debt crisis by forcing up borrowing costs. After nearly a month-long scapegoat campaign by the Prime Minister, the Greek daily paper, Kathimerini, uncovered that the biggest speculator, holding 15%, or \$1.2 billion of the total \$8 billion in these contracts, was a firm that operates two blocks away from the parliament building in Athens, none other than the Greek state-owned **Hellenic Post Bank**. Buyers have profited as the cost of five-year default swaps on \$10 million of government debt soared from \$118,000 a year in September to more than \$420,000.

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As we are now in the ISA Season, a particularly busy time of year for investment managers to promote their best funds, the average interest rate on Cash ISAs is now reportedly a whopping 0.47%!

It's therefore perhaps no surprise that at long last, private investors have turned positive on equities, according to research from Capita Registrars. For the first time since May last year, investor confidence was reflected in £121 million of net buying of equities in the three months to February, compared with significant selling in the previous six months. Recent trading has also seen a shift away from defensive stocks into cyclical.

Chancellor Darling has confirmed the government's support for implementing tax on the UK's banks, but only if the levy is internationally agreed. The UK is also to open a £2 billion Green Investment Bank. The bank, designed to help finance projects like railways, offshore wind power generation and eco-friendly waste management, will be half-funded from government asset sales, with the rest of the money coming from the private sector.

Lloyds Banking Group said that it expected to report a profit this year, as trading had so far been strong and provisions for bad assets were not as large as previously forecast. In a brief statement, the partly nationalised bank said that in the first 10 weeks of the year net interest margin was in line with guidance and income growth had been good. The trading update did not include any actual figures.

The bankruptcy tab just keeps growing for **Lehman Brothers**. The investment firm, which is still in the process of liquidation, paid its bankruptcy advisers and lawyers a total of \$678.5 million in the 17 months since it collapsed in September 2008. Sounds like a good case for some lucky law firm (nice work if you can get it!).

The trial in China of four employees of the British-Australian mining giant **Rio Tinto** has ended with guilty verdicts, on charges that the group accepted millions of dollars in bribes from Chinese steel companies and stole commercial secrets. The defendants unfortunately face seven to fourteen years in prison and have been fired by Rio Tinto for deplorable behaviour. The case will be closely watched by foreign companies operating in China.

In the oil sector, **BG Group** has announced impressive results from a test well at its potentially huge Santos Basin interests in Brazil, whilst **Royal Dutch Shell**, is shedding a further 2,000 jobs in a bid to slash costs. However, investors were soothed by news that the company is to maintain its dividend payout. Shell is also planning to exit a large chunk of its petrol business and sell off refineries as it focuses on improving its reserves replacement.

US Healthcare reforms, where everyone will have a right to quality care, have potential pros and cons for pharmaceutical companies. The pharmaceutical industry must now give increased rebates to government sponsored medical programmes, but whilst this may push up costs in the short term, in the longer term higher sales volumes could offset this, as more people with newly issued healthcare insurance start to access prescription medicines.

Sainsbury's like-for-like sales in its fourth quarter climbed just 1.7%, excluding fuel, dragging the full-year rate down to 4.3%. CEO, Justin King, noted that Sainsbury's own food price inflation is now just 0.4% and pointed to the difficulties it faces in dealing with cost growth that is outpacing sales growth.

Halfords continues to go from strength to strength and reported like-for-like sales up by 1.3%, in the 11 weeks to 19 March. The car maintenance operation was the main driver of growth, whilst Sat Nav sales slowed further.

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JD Wetherspoon, the purveyors of cheap beer (God bless them), has refinanced its debt and reinstated its dividend and trading has held up well throughout the recession - is that a surprise?!

Babcock and VT Group sealed a deal at last, with Babcock International offering VT shareholders £3.62 in cash and 0.701 new Babcock shares, in turn creating one of the UK's largest support services groups, with the potential to enter the FTSE 100.

Balfour Beatty's acquisition of **Parsons Brinckerhoff** has paid off, as the US-based services group has won three contracts to manage high-speed and intercity passenger rail projects in the US. The new work will swell Balfour Beatty's already impressive order book to £14.1bn.

Trading conditions remain tough for **Wolseley** across all its divisions. Since his appointment last July new CEO, Ian Meakins, has concentrated on streamlining the world's largest distributor of heating and plumbing supplies by reducing debts and cutting jobs.

Harley-Davidson's shares have risen on talk of a leveraged buyout, and Mr Kravis's firm, **Kohlberg Kravis Roberts**, is one name in the frame. The motorcycle maker could absorb plenty more debt, though the price tag and the cyclical nature of the business means a deal would be no easy ride...



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the View

A Thesis Asset Management view of the market



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