

OCT  
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# the View

A Thesis Asset Management view of the market



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## OurView



Michael Lally

***“And I can say today that every change we make, every single pledge we make, comes with a price tag attached” Gordon Brown***

The final conference speech ahead of a General Election is always one of the most important that a PM will have to make. This time I thought it best to sit down quietly afterwards and read it, rather than watch, thus analysis is not sidetracked by the impassioned emotion and gesturing with which they are usually delivered - although in Gordon's case it made no difference of course! However, the above extract is probably the most telling so well done for saying it as it is.

With many commentators having provided a myriad of reasons why the bull run in markets should have imploded in September it is perhaps worth looking at some statistics which I believe add more perspective than just focusing on the last six months' data. Taking the FTSE All-World index as a barometer of world equity markets, the returns emerge as follows (figures in parentheses are for the FTSE 350 Banks sector - more on this later!):

6m	+42%	(+88%)
2yrs	-30%	(-16%)
4yrs	-4%	(-46%)

The four year figure is the important one, the lack of any significant overall change in the All-World index arguably surprising given the level of earnings and dividend growth by the majority of companies (ie. ex banks) over this period. This is even more obvious when you look at the most recent bull and bear markets, ie:

	%change	index start	index finish
2003-07 bull market	+128%	206	470
2007-09 bear market	-57%	470	201

With the exception of financials (which singlehandedly fuelled the bull market and created the bear market) most corporate balance sheets are significantly stronger now than in previous recessions, indeed a major reason behind the (surprisingly) robust figures reported this year is the result of accelerated cost cutting measures and de-leveraging combined with restocking from historically low levels. This partly explains the recent momentum in markets and the 'second wind' underpinned by further unwinding of stale cash and short duration bond positions. Unfortunately this does mean that next year's figures will more accurately reflect the economic reality of higher unemployment, lower consumer spending (but higher savings ratios) and tight lending policies.

With negligible interest and inflation rates likely to remain for some time, the exit from cash has been attaining near panic proportions. In the US \$423 billion has left money market funds in the last six months - with the 12 week annualised pace of outflow rising from an average of \$200-\$300 billion in March-April to \$780 billion in September. Some \$2.5 billion has entered equity markets but \$254 billion has found its way into bond markets (in the case of government bonds and highly rated corporate bonds this partly explaining the anomaly of low yields despite entering a recovery phase).

A year ago companies couldn't give bonds away. Since then issuance at all levels of the credit spectrum has been heavy as finance directors turned to credit markets (from the banks that like to say "No") to reschedule debts, cover cash flow problems or merely take advantage of less punitive borrowing rates. Distressed buyers of yield are plentiful and whilst prices are now beginning to look more fully valued we remain buyers ourselves - this despite the somewhat disconcerting backdrop of virtually "every man and his dog" piling in (as evidenced also by sales of corporate bond funds this year). Hence some commentators are already talking of bubbles.

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*"Do not dwell in the past, do not dream of the future, concentrate the mind on the present moment,"* wrote Buddha. The reality is that corporate bond yields are now generally compatible with a backdrop of an extended period of low interest/inflation rates, whilst the current, albeit fragile, recovery - combined with balance sheet restructuring and tighter dividend policies - will improve key ratios such as interest cover and remove fears of downgrades. It won't be all plain sailing of course and, just as with equities, there will be further casualties and returns will vary between different companies and sectors. Although clearly some people have been buying for the wrong reasons, we believe that we are buying (or holding) for the right ones.



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## News



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### Markets

Indices	Value as at 30/09/09	% Change on Month	% Change 2009 year to date	% Change on 12 Months
FTSE 100 Share	5133.90	4.58%	15.78%	4.72%
FTSE All Share	2634.79	4.53%	19.26%	6.08%
Dow Jones	9712.28	2.27%	10.66%	-10.49%
DJ Euro Stoxx 50 €	2872.63	3.51%	17.18%	-5.45%
Nikkei 225	10133.23	-3.42%	14.38%	-10.01%
FTSE A British Government All Stocks	156.91	0.13%	-2.44%	6.26%

#### A rising tide floats all boats (well almost!)

Leading up to the quarter end markets continued their positive momentum, with the exception of Japan. It is perhaps unsurprising that after the best quarter on record for the FTSE100, the market has more recently run into some profit taking. The majority of stocks have enjoyed the rally, but the stand out performers remain those shares that took the most severe beating in the preceding period, ie. financials, property and retail. 'Quality', as a factor, has come a distant second to that of being previously perceived as 'oversold'. Decent businesses, defensive earnings and low levels of borrowing have lagged during the rally, but there are interesting signs, such as increased corporate activity that provide some evidence of a potential secondary phase in the offing. Cash weightings still remain high, the Cadbury's takeover appears a significant milestone with businesses now looking to the future again. That said, there is no question that given the economic malaise and the extent of the recovery so far, the next six months are unlikely to be as fruitful for markets in percentage terms. History corroborates, as the secondary phase of a recovery is always less significant than the first. However, there are still Bears that point out that this recovery is only a blip in a ten year Bear market, but this view appears extreme when looking at the performance of equities over ten year cycles - where

a decade can appear to have been lost between two points in time, without looking at the context of what's actually occurred during this period. There is currently an awful lot of chatter that we're now moving into a new era of capitalism, where more regulation, austerity and geographical power shifts will change the face of the world as we know it; therein surely providing some decent opportunities for investors.

#### News

Unsurprisingly banks have continued their strong run, significantly outperforming the market over the last month, but more defensive stocks have been at best virtually in-line with the FTSE100 or below. For example, GlaxoSmithKline, National Grid, Vodafone and Royal Dutch Shell have all failed to make decent headway and defensive stocks in general have typically fared much worse in both relative and absolute terms.

Some 'smarter' economists are viewing the weaker pound as a potential lifeline for the future of the UK economy, where the ability to export our way out of trouble could potentially come to the fore. This may certainly not be an immediate effect, but with the ongoing industrialisation process occurring in emerging markets, increasing domestic demand and healthy account surpluses, this idea has legs. Whilst the 'early money' made from Asian economies has been driven

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## News



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by the commodities story (surely no longer new news to anyone now?!), the next stage could potentially be driven by an increasing demand for goods and services - Unilever, Standard Chartered and Prudential are all good examples of UK businesses expanding profitably into Asia.

Turning to company specific news, insurer **Aviva** completed the reattribution of the 'inherited estate' in its CGNU and CULAC with-profit funds worth £470 million to policyholders. Customers will automatically start receiving their payments from early November with most receiving them by the end of the year. The company said 90% of payments will be between £214 and £1,230.

**Friends Provident's** takeover by Clive Cowdrey's **Resolution** has helped lead resurgence in the life assurance sector and there are rumours they could also strike again, possibly at **Legal & General**. This is despite the fact that the sector may have to find £50 billion of fresh equity. All life assurers may have to increase their capital and reserve requirements in the UK due to impending legislation, so called the Solvency II Directive rules which may come into force in 2012 - this almost equates to the Market Cap of the whole insurance sector!

One year after **Lehmans**, **Barclays** came up with possibly the most controversial deal of the month, by selling off £12 billion of toxic assets to a Bermudan shell company called **Protium**, managed by 'ex-staff' and financed by a loan supplied by, guess who... Barclays. This is seen as a stability measure to reduce earnings volatility, by sacrificing potential upside to limit any downside. Nice work if you can get it! Elsewhere, speculation continues on whether **Lloyds** and **RBOS** will come 'cap in hand' to shareholders, in order to reduce their participation in the Asset Protection Scheme.

Cost cutting remains the order of the day for **Reed Elsevier**, which is closing a business in Holland to streamline operations and also the packaging company, **Rexam**, announced plans to close a beverage can factory in France.

**BP** made a giant discovery in Gulf of Mexico, on a project where it has a 62% controlling interest and the share price rose as a consequence given its great potential. **Royal Dutch Shell** had production licences granted by the Australian Government, which also bodes well for them. **Amec** has won a major contract with **Exxon**, the size has not been disclosed, but it has been described as 'significant'.

**Vodafone** confirmed they are not bidding for **T-Mobile**, which is forming a joint venture with **Orange**. **Anglo American** has told **Xstrata**, via the Takeover Panel, to 'put up or shut up', in respect of their potential takeover. **Smith and Nephew's** shares have run better, as they continue to be a perennial takeover target.

**Balfour Beatty** announced plans to acquire New York's **Parsons Brinckerhoff Inc.** for \$626 million, bringing into the fold a firm that has been at the center of large US construction projects including the World Trade Center, Boston's Big Dig and NORAD. Balfour is funding the deal via a rights issue. The deal brings together two firms that have built airports, hospitals, bridges and other major projects all over the world. However, the marketplace for these projects remains slightly challenging, as governments and large companies put some big projects on hold. Meanwhile **Taylor Wimpey** is exploring the sale of its troubled US housing business.

Sources say **BAE Systems** is reportedly keen to settle the alleged bribery case being investigated by the Serious Fraud Office, but only if there is compelling evidence of culpability...

Finally, a heart-warming story that proves that even in these dark and dreary economic times, some businesses can still prosper. 'Real Ale' has lifted its share of the beer market in pubs and clubs from 11% to 13.5%, after recruiting some 400,000 new drinkers! Perhaps this serves to prove that more of us now simply feel the need to turn to beer...

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