

SEP
Sep 2009

the View

A Thesis Asset Management view of the market



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OurView



Michael Lally

"They think it's all over... it is now!"*Kenneth Wolstenholme, 1966 World Cup final*

With both markets and economists agreeing (and that doesn't happen too often) that the recession officially ended in June/July then the continued rally in financial markets, but equities in particular, appears to be reasonably well underpinned. The focus is still on those areas, such as the Asian and Emerging economies, where not only were they less exposed to the banking crisis to start with, but they are also highly sensitive to any recovery in global economic activity.

This explains the dramatic rise in prices in these markets this year, also (in terms of sensitivity to recovery and lower risk aversion) in the medium and particularly small cap areas of the main markets. Arguably they have probably run a little ahead of events short term and should be due some correction, as indeed should some sectors of the leading markets. Six months of virtually uninterrupted growth is unusual, given the fragility of the recovery, but perhaps not entirely surprising as momentum has been maintained by a gradual restoration of risk appetite - as opposed to the more spectacular shorter term recoveries so often seen in previous scenarios.

This is of course all manna from heaven for those, like me, who do not hang their hat on one of the many rigid mathematical models or historical precedents. Indeed many would argue that their sheer inflexibility was a significant factor in the near catastrophe in financial markets last year. Whilst I do, however, agree with the concept of longer term mean reversion, in the meantime prices are driven by three main criteria, ie. emotion (fear and greed), supply and demand. A good example of this is the relationship between gilts and equities which, convention decrees, should always move in opposite directions. In the May issue, for example, I forecast ***"Don't be surprised... to see both gilts and equities moving in the same direction for periods this year"***.

I have to admit that I didn't expect the market to oblige quite so quickly but this scenario duly occurred in July and August. The reasons for this confluence were already in place, therefore it was only a matter of time before prices behaved accordingly. The three key drivers have been:

- 1 Most market participants now buy into the concept of an extended period of low interest rates and, thanks to significant spare capacity, subdued inflationary pressures. Good for gilts.
- 2 Vast amounts of government cash are supporting virtually all assets, and in the UK the quantitative easing (QE) program is directed primarily at purchases of government bonds with a view to kick-starting bank lending. Good for gilts (short term) and for equities.
- 3 Any economic recovery reduces the potential for sovereign default (as feared by some doomsters in February), and implies a reduced potential supply of new bonds. Bond yields fall which then makes equity yields more attractive. Good for gilts (short term) and equities (medium/longer term).

Obviously this correlation cannot continue indefinitely, and we have been taking advantage of these conditions to reduce exposure to gilts - notably at the extreme ends of the yield curve, ie. the shorter and longer dated issues. On a one to two year view we believe that there is better value in corporate bonds, particularly higher yielding as the top grade bonds are more sensitive to gilt prices and interest/inflation trends. Indeed, because of the unique nature of the current economic scenario, we view medium and lower grade bonds as an equity proxy but with potentially less downside risk - particularly if purchased via a specialist managed fund.

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OurView



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So there are, to quote the 1979 hit of one of my favourite bands (Ian Dury and the Blockheads), '*Reasons to be cheerful*'. However it is important to temper any enthusiasm with the reality in the important banking sector. Reserves are now three times, ie. £100 billion, higher than the levels when QE began. Everyone knows that lending is strictly rationed, but it would be wrong to assume that this is merely a short term dam of credit waiting to burst. Not only are banks rebuilding their balance (and particularly off-balance) sheets but they are also painfully aware of the dramatic rise in write-offs of non-financial corporate debt (up 40% in Q2) and unsecured debt (now 5.5% of household's outstanding unsecured bank debt). House prices appear to have stabilised but unemployment is heading towards 10% and combined with tougher lending criteria it could be a very cold winter for many.

This raises the question of whether the spectre of a credit-less recovery is a viable proposition. Fortunately, this is not an issue yet, as investors are currently happy to stump up the cash for both equity and bond issuance and, unlike previous post recession scenarios, most corporate balance sheets - in direct contrast to their government counterparts - are in a much healthier state.



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Markets

Indices	Value as at 31/08/09	% Change on Month	% Change 2009 year to date	% Change on 12 Months
FTSE 100 Share	4908.90	6.52%	10.71%	-12.91%
FTSE All Share	2520.66	7.10%	14.09%	-12.13%
Dow Jones	9496.28	3.54%	8.20%	-17.74%
DJ Euro Stoxx 50 €	2775.17	5.19%	13.20%	-17.54%
Nikkei 225	10492.53	1.31%	18.43%	-19.74%
FTSE A British Government All Stocks	156.70	2.61%	-2.57%	6.15%

“Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria” Sir John Templeton

Things have certainly not been quiet since the last edition of TheView back in early July, with the FTSE 100 up a staggering 15.5%. The strength of the rise appears to have caught many commentators on the hop, who are now urging investors to be careful as the market has run too far ahead of itself and ‘any letter shaped’ economic recovery. However, with shareholders having enjoyed their biggest summer gains in a quarter of a century and with plenty of cash still waiting on the sidelines and many now wanting the market to retreat, the chances are that this run really could be sustainable and not just a ‘flash in the pan’.

Markets never tend to go up or down in a straight line and are clearly prone to over reaction, both positive and negative, but it would appear the foundation for this current rally has been driven by hope, rather than relief or optimism. Global economic indicators are now turning supportive of those who say the worst is behind us; indeed, there have been unprecedented positive moves in economic indicators. For the first time ever all 39 countries’ leading indicators recorded monthly increases and these increases are the highest since records began 47 years ago. Could it just be possible that policymakers have started to achieve what they set out to, that journalists are ignoring positive news (as bad news always makes a better story) or that the speed of the turnaround really does mean we are simply storing up more problems for the future? Whatever the outcome, the world has moved from the fear of losing money to the even bigger fear of being left behind in the stampeding herd!



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Since our last update much has been reported in the banking sector. Results for the non-state owned banks have generally been better than expected. Common themes were strong investment banking revenues (especially **Barclays**) from debt and currency trading, allied to less capacity as other participants withdrew from the market; much higher bad debt charges, but these now seem to be stabilising and improved Tier 1 equity ratios (their capital cushion), which are around 8% or better.

Barclays first half profits were £2.984 billion. These were good figures in the circumstances, but with the sale of BGI, Barclays will become even more dependent on Barcap and the critical question is how sustainable are these profit levels? In the short term, Barcap could account for up to 60% of profits, but the group's long term target is about 35%.

At **HSBC**, profits were \$5.019 billion. HSBC showed its financial strength with these figures, which were not affected as some expected by a \$4.7 billion accounting 'funny' as strictly required under IAS 32. This was over the rights issue being launched in a different currency from which it usually reports. The key to the group's future is its US personal financial division, which is still a major drain on profits.

Standard Chartered delivered profits of \$2.838 billion, +10%, ahead of expectations and it is the only bank likely to increase its dividend this year. The share price edged down on the day of the results because of a surprise share placing, allegedly to improve its capital reserves, and to provide funds for selective acquisitions rather than to cover further loan provisions.

In terms of accounting 'funnies', **Lloyds** took the biscuit... Depending on your viewpoint, you could either consider the more meaningful 'pro forma' first half loss of £3.96 billion, or a statutory profit, (yes, I do mean profit) of £6 billion after a £11 billion 'negative goodwill gain' (from a lousy acquisition!). Similar to others, the key issue is the level of bad debt impairments - at £13.4 billion, 80% from HBOS lending, particularly commercial property. However, in the short term the market seems to have sided with management's view that impairments have now peaked and Lloyds are expecting house prices to

stabilise in 2010. More recent stories point to asset sales and capital raisings, ahead of any forced interventions from the EU over market share.

Northern Rock remains an interesting case of how wrong things can go! It announced 39% of its mortgages are now in negative equity (v 13% at Lloyds) and 4% are more than three months in arrears (the industry average is about 2.5%).

Insurer **Aviva** swung to a profit after tax for the first six months of 2009 from a loss last year and announced plans for a partial IPO of its Dutch business, but still cut its dividend by 31%. The company said it has started the ball rolling on its idea for a partial IPO of Delta Lloyd on Euronext Amsterdam. The interim payout was dropped to 9p a share from 13.09p a year ago, but the overall dividend policy remains unchanged. Elsewhere, **Friends Provident** agreed to be taken over by Resolution, Clive Cowdery's acquisition vehicle, in a staggering deal worth £1.9 billion.

Turning to non-financials...

BSkyB saw its revenues climb 7% to £5,323 million, providing evidence to the anecdote that more people are staying in to watch TV. Annual revenue per user (ARPU for you techie types), reached a new high of £464, driven by the success of Sky+HD and growth in broadband and telephony customers.

Reed Elsevier reported reasonable results, but surprised the market with a £824 million placing to reduce debt, following suspended asset sales. The Daily Telegraph reported that new CEO Ian Smith now views B2B group RBI as a core part of the group, and plans to retain the bulk of it rather than divest it.

Unilever saw volume growth return in its second quarter with sales up 2% versus estimates of a small decline. This also compared well with major rival **Procter & Gamble**, who saw a 1% fall in sales and 4% decline in volumes. However, margins were hurt by price cuts and higher advertising spend.

In the transport sector, hopes of a deal for **National Express** have now virtually evaporated, whilst **Arriva** reported reasonable results. David Martin, chief executive of Arriva, commented: 'Although the short-term outlook for passenger revenue growth is difficult to predict, we are confident that the group will continue

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to demonstrate its combination of resilience and growth potential. This is reflected in our decision to increase the interim dividend by 5%.' Such news in the current environment is always welcome.

Premier Oil shares continued their buoyant run. The company moved quickly to take advantage of good quality acquisition opportunities which arose earlier in the year at a time of weakness in oil prices and shortages of available funding. As a result, the company has entered an exciting stage of its strategic development. Over the next twelve months, it expects to deliver optimal outcomes for its Asian development projects and look forward to further exploration successes in Vietnam and Norway. Oil majors, **BP**, **Royal Dutch** and **BG Group**, all reported reduced results in-line with market expectations and the lower oil price, but dividends are being maintained.

Carillion reported solid interims, with some excellent growth coming from the Middle East. The company posted a 17% increase in first-half pre-tax profit and said it was on track to deliver materially enhanced earnings for the year. **RPS** results were in-line with consensus, with a 15% increase in interim dividend and profit before tax of £29 million versus £28.5 million last year (+2%).

BAE Systems share price has suffered of late over fears of a slowdown in defensive spending, yet the underlying results were as expected with revenue up 28% (+6% on like-for-like basis). The dividend was also increased by 10.3% to 6.4p and the order book rose to £45 billion, following the signing of a major contract for another 112 Eurofighter aircraft.

The coming month is likely to be an interesting one now that holiday season is officially over... If recent trends are anything to go by, I predict that results will be better than expected and opportunistic capital raisings will abound.

Source: Chart courtesy of Fidelity International - Perspective August 2009



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