

Thesis Market Commentary

August 2011

“ ‘Should have gone to Spec Savers’ runs the TV ad, and reading the wave of very optimistic forecasts for equity markets from the City it seems that sales of the rose tinted variety must have been at record levels...growth in markets will be constrained (and occasionally rudely interrupted) by the long and painful process of deleveraging, particularly at sovereign and household levels.” *The View, January 2011*

Having fallen by a third in 2008/09, as a result of the banking crisis, equity markets actually ended last year 5% above their May 2008 peak - hence my cautionary tone back in January. The problem is that markets seem to have disassociated (non financials) corporate health from the potential repercussions of the chronic sovereign debt problems. This was based on the not entirely unreasonable assumption that the politicians and central bankers would find an amenable solution. GDP figures would hover 1% - 2% above zero, and - underpinned also by Emerging economies' demand - companies could carry on as normal.

Unlike Gordon Brown, markets love a “quick fix”- however painful the consequences. Look at how the share price of a fallen angel often rallies when it has completed a heavily discounted rights issue and/ or debt restructuring exercise. Therefore the accelerated falls over the last week in particular are not so much down to the various ‘shock’ announcements but the realisation that, unlike the bale out of the banks, this time there is no universal remedy. Instead we can expect a series of initiatives to treat the bad debt cancer, with occasional periods of remission, but an extended period of uncertainty before one can reasonably begin to assess the treatment as successful. The fact that not one but a whole range of ‘patients’ are being treated at the same time, with the equivalent of an NHS style constrained budget, complicates the issue further.

Are we there yet?

As we are in the middle of the peak holiday season I am reminded, like most parents, of this classic four word incantation from impatient children as you sit in a 3 hour traffic jam on one of our beloved ‘A’ roads, on the hottest day of the year, with no air conditioning, a near empty tank but a full to bursting bladder! I have taken many calls over the last few days, not from clients asking whether to sell, but when is the right time to buy.

Despite the shock media headlines, by historical standards the 14% decline in world equity markets over the last month was relatively modest. Whilst there is the likelihood of a shorter term ‘dead cat bounce’, it does therefore still leave room for further falls before valuations become so compelling that a more sustained recovery is possible. First of all let’s take a look at two key valuation indicators, as demonstrated by the data, as at last Friday’s closing prices, for a selection of major G7 markets:

Equities & Government bonds ▼

Country	Equities		Government bonds
	P/E ratio	Dividend yield	10yr benchmark yields
UK	10.6	3.8	2.8
USA	13.1	2.1	2.5
Japan	17.7	2.0	1.0
Germany	10.0	3.9	2.3
France	9.9	4.8	3.2

In terms of income yields (and in a very low interest rate environment) the above table appears to suggest that either these equity valuations are too low, or government bond prices too high (particularly as most are well below their respective inflation rates!). The reality is that in a higher risk world, investors are prepared (or forced) to pay a higher premium for risk free assets and demand a higher yield/lower valuation on risky assets. An aggressive policy of share buy backs over the last 10 years combined with debt reduction (or rescheduling on lower interest rates) have enabled companies to increase dividends at or significantly ahead of inflation.

Price Earnings ratios (ie. the number of years it would take earnings per share to equal the current share price) are only, of course, one of many indicators of value and - based upon their level at one point in time - are not an accurate barometer for forecasting precise entry and exit points. However, taken in the context of moving averages, both shorter

and longer term, the case becomes more compelling. The median average P/E ratio for the S&P 500 index, since 1920, is 15, but it has trended upwards from 12 to 21. At the extremes it has traded down to around 6 times and up to the mid 40’s (during the tech boom).

Based on current earnings forecasts then forward P/E ratios for 2012 and 2013 are well into single figures. On paper this would seem to suggest that the market is heading into what I would term very good value territory - but not irrationally cheap. If the developed world economies do head back into recession, then earnings forecasts for many companies will eventually have to be revised downwards. It is an unfortunate coincidence that just as the developed world economies are trying to stimulate growth, the emerging economies, led by China, are endeavouring to dampen down inflationary forces.

Equity markets thrive on the known (or expected) and panic on the unknown (or unpredicted - aka event risk). Because none of the European leaders, or US politicians, can agree on anything other than a series of temporary ‘finger in the dyke’ solutions, then it is very difficult to make any sensible forecasts as to the likely trend in earnings growth over, say, the next 2 - 3 years. Until there is greater clarity, both as to the effectiveness of existing and yet to be agreed strategies, and also their implementation, then markets are likely to remain range bound (ie. 10%-15% either side of current levels) for the rest of this year and possibly 2012 as well.



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Market News

Comparative Index performance ▼

Indices	Value as at 31/07/11	% Change on Month	% Change 2011 year to date	% Change on 12 Months
FTSE 100 Share	5815.19	-2.20%	-1.44%	10.60%
FTSE All Share	3026.02	-2.28%	-1.20%	11.44%
Dow Jones	12143.24	-2.18%	4.89%	16.03%
Euro Stoxx 50 EUR	2670.37	-6.25%	-4.38%	-2.62%
Nikkei 225	9833.03	0.17%	-3.87%	3.10%
FTSE A British Government All Stocks	160.44	3.06%	2.60%	2.26%
Sterling/US\$	1.6426	2.32%	5.21%	4.70%
Sterling/Euro	1.1410	3.07%	-2.18%	-5.14%

➔ Much can change in a week...

As I frantically put pen to paper the FTSE 100 has closed 500 odd points lower than at the end of July. As so often with increased market volatility one always questions what is so different today that we didn't already know yesterday? On occasions such as this one, I must confess I struggle to find an answer...

Over indebted Western governments are likely to continue to effectively defraud holders of both their currencies and debt over the longer term. In a fragile economic environment, inflation (or perhaps stagflation) continues to go unabated and the only solutions to this mess is fiscal tightening, further Quantitative Easing and various forms of unofficial defaults and currency support mechanisms. The Eurozone crisis will rumble on and on.

Meanwhile, in the emerging world the industrial revolution of the 21st Century continues, fuelling global growth of some 4.1%, which to readers of the UK press is probably quite surprising. In addition, this factor is continuing to fuel global inflation of 4.5% (CPI).

Global businesses keyed into this growth remain flush with cash and this continues to help drive increased mergers and acquisition activity. Gold also continues to rally as the new safe haven of choice. Surely there must be a disconnection of logic somewhere and leaving financials aside, I personally cannot think of a better place for longer term investors to be in than quality Blue Chips, emerging markets, index-linkers, together with a healthy smattering of gold.

Finally, a most telling story of our times, with the delay of the US Government's efforts to raise its debt ceiling it ended up holding less cash on its balance sheet than the tech giant Apple. As of 27 July, the US government had a total operating balance of \$73.8 billion, according to figures released by the US Treasury, whilst Apple's latest financial results showed cash reserves of some \$75.9 billion!



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Autos

Toyota reported a 99% drop in quarterly profits because of the impact of March's earthquake and tsunami. Toyota was hit by a shortage of parts around the world due to the damage caused to Japan's supply chain. Despite falling first quarter sales, Toyota increased its forecast for full-year sales and profits.

BMW has said that its second-quarter profit more than doubled. Net profit rose to €1.8 billion from €834 million in the same period last year. The owner of Mini and Rolls-Royce also sold a record 450,608 vehicles, a year-on-year gain of 18.5%. The results were boosted by growth in the lucrative Chinese market, where its sales rose 52% from last year.

Financials

Barclays has reported pre-tax profits of £2.6 billion for the first six months of the year, down 33% from last year. The bank also said it aimed to cut at least 1,400 more jobs in 2011, having cut 1,400 posts already this year. The fall in half-year profits was partly caused by a £1 billion provision for settling claims of mis-selling of payment protection insurance (PPI). The bank also reported a big drop in bad debts and said it was on course to meet targets for UK business lending.

HSBC is set to hire up to 15,000 in Asia and Latin America over the next three years, whilst trimming 30,000 jobs worldwide by 2013. Guess where the growth is then?

Elsewhere, the UK Government's sale of **Northern Rock** will crystallise a loss of at least £400 million for British taxpayers.

RBS got slammed in the market after reporting their results and blamed the European crisis and PPI claims for its £1.4 billion losses in the first half of 2011. The bank is preparing to offload £1.4 billion of high-risk debt after striking a deal with the private equity company **Blackstone**.

Hugh Osmond has reportedly turned his attention to banking with an ambitious offer for 630 branches being sold by **Lloyds Banking Group**.

JO Hambro Capital Management (JOHCM) is to be bought by Australian fund manager **BT Investment Management (BTIM)** in a £209 million deal. BTIM will buy JOHCM's £7.1 billion asset management business and take a 9.9% stake in its private client arm.

Market News

Oils

Gazprom, Russia's state-owned gas giant, is in talks to take a big stake in British power plants owned by **RWE**, German parent of the utility **Npower**.

Tony Hayward's **Valleres** is considering a takeover of two Russian oil producers in a deal that could be worth up to £8 billion and the Abu Dhabi listed oil and gas company **Dana Gas** has also emerged as one of its possible bid targets.

India's cabinet committee approved **BP's** purchase of a 30% stake in an oil and gas venture with India's **Reliance Industries**.

Miners

Aussie miner **BHP Billiton** is to buy **Petrohawk** for \$12.1 billion and **Anglo American** forecasted a strong end to 2011, as it recovers from a weather-battered start to the year - production is set to increase and rising metals prices are helping to offset continued pressure from 'dramatic' cost inflation.

Kazakh miner **Kazakhmys** posted a 7% dip in first-half copper production in line with expectations, but said it was on track to meet its full-year targets. **Xstrata** has made an all-cash bid for privately held Canadian miner **First Coal Corporation**, with an offer valuing the firm at \$153 million.

Rio Tinto's majority-owned **Coal & Allied** reported a 41% jump in first-half profit, which was lower than broker forecasts as revenue came in weaker than expected. Finally, **Glencore** is reportedly lining up a \$475 million acquisition for one of Peru's largest copper prospects.

Retail

Thomas Cook, the beleaguered tour operator, is to sell more than £200 million of assets to help shore up its finances.

India's **Cox & Kings** has proposed to buy **Holidaybreak** in a deal which values the London-listed company at £312 million.

Moonpig.com, the online retailer of personalised greetings cards, has been acquired by the digital photo service **Photo Box** in a £120 million deal.

Telecoms

Vodafone - despite trouble in Europe many shareholders were encouraged by hints that **Verizon Wireless**, Vodafone's US joint venture with **Verizon**, will restart paying dividends next year. The company has also agreed to pay an additional \$460 million for a stake in its Indian business, **Vodafone Essar**, bringing the total cost to \$5.46 billion, as the mobile phone group seeks to avoid a new tax dispute with the Indian authorities.

Other News

BSkyB announced a planned share buyback worth £750 million and said it would return another £253 million to shareholders through a final dividend of 14.54 pence a share.

British American Tobacco is in talks to buy Bulgaria's state tobacco company in a deal worth up to £100 million.

Northumbrian Water has accepted a takeover proposal worth £2.41 billion from **Cheung Kong Infrastructure**, a company controlled by Li Ka-shing, Hong Kong's richest man.

Willie Walsh wants to merge Portugal's **TAP** with **British Airways** and **Iberia** in a deal that could give him a foothold in the rapidly growing Brazilian market.

Charter International moved to bolster its defences against an unwanted £1.4 billion takeover proposal from **Melrose**, as the engineering group revealed plans to cut £38 million in costs as well as targets to get its troubled welding operation back on track.

Lastly, a reason to be cheerful, two-thirds of the US companies in the S&P 500 Index have now reported Q2 earnings and 73% of those have exceeded analyst expectations.

Sources: Reuters, Citywire, Investment Week, and BBC News.

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