

Thesis Reaction

12th August 2011

Stock markets - where to now?

Given the high profile and alarming media coverage always given to sharp market corrections, and the concern that this may engender amongst clients, Thesis held a conference call yesterday afternoon with a specialist panel of advisers to discuss their interpretation of events, and the strategies they are adopting to protect portfolios in a more challenging environment.

We thought it would be useful to pull out the key points for you.

Michael Lally

US ratings downgrade and Fed commitment to peg rates for 2 years signals deflationary low growth outlook - bad for banks and good for Treasuries. Dollar unlikely to fall heavily as it's still by far the largest most liquid currency and will be underpinned by stronger/emerging economies keen to peg their own rising currencies.

Don't rule out a series of concerted shorter term political initiatives to appease markets. This will increase the risk on/off sentiment with markets range bound - probably throughout 2011/12 - within a fairly wide band (10%-15% of current levels). Our strategy will be to capitalise on this by generating buy and sell signals towards the extremes of these ranges.

Matt Hoggarth

Further restructurings of Eurozone periphery debt seem likely to occur, as the EFSF would need to be expanded if debt issuance becomes difficult for Italy and Spain (as seemed probable before ECB purchases of their bonds started last week) and that expansion would place too large a burden on Germany. It is vital that any restructuring is carefully stage-managed to avoid adding fear to the markets, especially given the effect it could have on bank capital adequacy.

Even if debts are restructured, there are still significant issues of competitiveness in the periphery which can only be solved by long-term structural reforms (which will be difficult without sustained growth or large fiscal transfers from the core) or currency devaluation. Hence a fracturing of the euro into two or more currencies seems possible. Again market movements here are dependent on political events.

Steven Richards

Actively Managed Funds have generally fared better than market indices August to date, whilst despite all the focus being on equity markets, equity managers have generally done relatively better than Fixed Interest Managers. 65% of Thesis' fund selections have outperformed their respective indices August to date. Unlike 2008, this (sovereign) credit crisis hasn't also become a liquidity crisis and our alternative asset class fund selections have acted as diversifiers and even absolute performance contributors.

Early in 2011 we noted a rotational trend into value/income oriented Funds and also that dividends were predicted to grow faster than corporate earnings. We have therefore biased towards equity income funds even in areas such as the Far East and Emerging Markets

and as history has shown previously, such style funds have again been relative out performers in these down markets. We continue to focus towards these plays for the foreseeable low growth or even recessionary future.

Giles Marriage

The UK equity market does not currently look expensive on a Price Earnings Ratio of 9x versus history and subject to the avoidance of a double-dip recession, which would inevitably lead to earnings downgrades. Some decent opportunities do exist and investment trust discounts have widened significantly in certain sectors (ie. private equity).

We remain significantly underweight to banks, which have been the most volatile sector over the last two weeks and are very susceptible to on-going solvency issues within the Eurozone.

Question

If you are a cash investor would you view this as an opportunity right now?

Answer

Michael Lally: It's much easier at the moment to be selective in terms of individual direct equities. I think where you've got a collective portfolio it's far more difficult. One of the things we have agreed on in terms of our strategy going forward is that equity markets in particular are likely to be range bound for quite a long time and within a fairly broad range. In other words, we are looking now to take advantage of swings in the ranges, probably 10-15% either side of where the market was on Monday; so what we are doing is fixing levels for markets, so if people are thinking of buying a market or a broadly based fund, we

CONTINUED ON P2 ▶



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are looking at levels in that market at which we might buy and sell. In terms of day-to-day, as a house we generally aren't day traders. There are a lot of opportunities at the moment where the market could be up 250 points in the next 2 days and 300 points 2 days after that. The majority of clients that are investing are actually investing on a slightly longer term basis than that. So coming back, it's certainly an opportunity in direct equities because they're much easier to value. If you're buying a broadly based index, if someone was coming to me today we would probably put them off and look for a level of I guess, somewhere of about 5% below where we are now.

Giles Marriage added: The key thing for me is the market now at the current level is trading on a PE of around 9x, looking further out into the future and on a longer term basis I would argue that that's a very good valuation to be taking and getting involved with. In the short term, very difficult to know which way it's going though.

Michael Lally added: What we would say though, is if you had a client that came along with a £100,000 or £1 million and they handed the cheque over to Thesis today, we would be managing that investment very carefully. New clients that I have been dealing with over the last 6 months, in some cases we have suggested that they might want to hold half back for 6 months or a year and go in in two goes. One thing I wouldn't do is commit an entire portfolio on one particular day.

Question

Have you ever thought about a euro bond to cover all the states in the euro to give it a bit more credence so everyone can key into the strength of Germany?

Answer

Matt Hogarth: I think that ultimately, that's very desirable in terms of it being very unusual having a currency union that isn't also a fiscal union because you get these imbalances that we're seeing at the moment. Whether a common bond is a possibility politically is a different question at the moment.

Clearly there is quite a lot of negativity among the electorate in Germany towards bailing out the 'profligate southerners' in the union, although we have seen figures that suggest that Germany is better off to the value of about £80 billion per year from the opportunities that the single currency provides for efficiencies and better access to markets and therefore it is in Germany's interest to a certain extent to provide support for these other countries. I think, in answer to the question, that ultimately it will come, but it's not going to be short-term, and it needs to be worked out politically very carefully.

I think the key thing as well is that Germany will ask for very strong guarantees from the other states in terms of their fiscal policies, so they lose a bit of independence for Germany to commit to standing behind that common bond. And so there is a bit of horse-trading to be done there to get that regulation onto a firm legal standpoint.

Question

Would you agree that politically ultimately there has to be a solution?

Answer

Matthew Hogarth: Yes, economically there has to be some solution to this debt. Since '08 we have taken private sector debts into the public sector as financial institutions have been bailed out and the huge fiscal deficits have been run to try and kick start the economy. We're now in Europe seeing the unsustainable public debts being moved into supranational institutions, and now we're talking about bail-ins and so forth moving them back to the private sector. You can kick the ball down the road for a certain amount of time but at some point we have to see these elevated levels of debt relative to GDP reduced because they will be a political burden, a burden on growth, and lead to the kind of volatility we are seeing in markets at the moment. Politically there has to be a solution, but the question is when and how that comes.

Michael Lally: We think that within 3-5 years there will be some form of break up. Four big solutions:

- **De-value the Euro:** it would have to drop about 40% against the \$ and Germans can't accept that
- **Engineer Growth:** which is what the politicians can talk about but can't do
- **Massive structural reform:** cutting labour costs, putting up productivity. That's the best option and Germany did it very successfully but it did take them 15 years.
- **Temporary deflation:** Argentina tried it and gave up after 3 years.

What clients want at the moment of course is not a crystal ball, but reassurance. Along the lines of stick with it, the sun's still going to come up tomorrow morning. Just because the stock markets tanked doesn't mean your risk profile changes. They just want reassurance, which they're not getting from the BBC or Robert Peston. That is part of our role to put it in perspective.

At the moment everyone is talking about generalist ideas and stop gaps but they are all temporary solutions. The biggest one, as we know from the past, is when countries have problems - apart from structural reforms - they have allowed their currency to float to a level where they become competitive again. If you're going to achieve that then there's got to be some sort of breakup of the union. I can't see how we can avoid that.

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