Friday, 4th January 2013

HB Markets View: 2013

Equity Markets are cheap by any measure… Growth, Balance Sheet Strength and Dividend Yield are key for our SEVEN Stock Picks

How UK Equity Markets have fared over 2012

Index	%
FTSE 100	6.3
FTSE All Share*	8.6
FTSE 250*	22.3
FTSE Small Cap*	24.3
FTSE Fledgling*	16.5
FTSE AIM All Share*	2.4

**ex Investment Companies*

Source FT 29/30 Dec 2012. At close On 28/12/2012; since 30/12/2011

How Major Overseas Equity Markets have fared over 2012

Index	%
USA S&P 500	11.5
USA Nasdaq 100	14.4
USA DJ Industrial	5.9
Japan Nikkei 225	22.9
Germany XETRA Dax	29.1
France CAC 40	14.6
Hong Kong Hang Seng	23.0

Source FT 29/30 Dec 2012. At close On 28/12/2012; since 30/12/2011

Considering the lack of GDP growth in 2012, particularly in the developed economies, the returns are surprisingly good. In the UK there are a couple of anomalies in the FTSE 100 and the FTSE AIM All Share returns.

Dealing with the FTSE 100, it often throws peculiar performances as it is a capital weighted index and big companies have the biggest impact. The sectors that underperformed included Oil & Gas, Pharmaceuticals & Biotech, Telecoms and Mining. Whereas Banks, Retailers and Household Goods outperformed the index.

Moving on to AIM, liquidity issues have dominated the market, as market markers are reluctant to take positions and, with many constituents seeking further funding, can lead to a loss of confidence and prices are savagely marked down.

Most City stockbrokers appear to be indicating a 10% rise in the FTSE 100 - some even beyond 6500 (as at 28th Dec 2012 FTSE closed 5925.37). Apart from an exercise in guessing, what I do know is not necessarily where the UK equity market will be in 1 year from now, but that on most fundamental and historical measures it is cheap. Long-term investors should be buying UK Equities.

Valuations

Price/Earnings ratio

Forward consensus estimates indicate a growth rate for company earnings in 2013 of nearly 10% putting the forward FTSE 100 P/E ratio at just over 10x.

In an historical context the late 1960's saw a P/E ratio in low 20x; 1970 saw PE down to its long term average of 14x. In 1972 back to 20x and then the real banking and property crash of 1973/4 when the P/E fell to under 5x!

From there, with a few peaks and troughs, the market regained some composure to rally the P/E in 1985 in the high teens. It fell back in late 1980s to early 1990 (house prices falling and negative equity) to 10x. A strong rally in the early 1990s saw P/E rise again to 22x before a fall back to the long-term average of around 14x. Then came the 5 year rally in 1995, to a P/E of 27x and then the dotcom fallout which saw an 8 year decline in P/Es to the low in 2008 of 7x (post Lehman's) and the short lived rally, of 2010.

The long-term average trailing P/E over 40 plus years is just under 14x.
Equities cheap

Yield

Firstly there are only 12 stocks in the FTSE 100 that yield less than UK 10-year gilts. Over 80% pay a yield exceeding UK 10-year gilts. (5 don't pay a dividend). In 2008, it was 70%, and pre the turmoil in financial markets, less than 5%! In the 2002/3 55% had a yield greater than the UK 10-year UK Gilts. I am grateful for Citi Research for pointing this out. Between 1969 and 1997 never more than 10% of the FTSE yielded more than UK 10-year Gilts.

Gilt yields are historically very low and UK equities yield nearly two times the UK 10-year Gilt yield. Equities cheap

The Importance of Dividends

Professors Elroy Dimson and Paul March have produced annual research on Small Companies with results going back to 1955. The Numis Smaller Companies Index (NSCI) charts the annual capital returns of the FTSE All Share, the NSCI and the NSCI 1000. They have also produced analysis on dividends re-invested over the same period:

£1 invested in 1955

Index	Capital Gains £	Total Return £
FTSE All Share	51	598
NSCI*	194	2963
Numis 1000*	347	6671

From a conference report dated 26 06 2012

*The NSCI measures the bottom 10% of the FTSE All Share by market capital and the Numis 1000 measures the bottom decile of the NSCI (i.e. the very small companies)

There are two messages here:

1. Small Companies outperform big companies in the long term, and the smaller the companies, the bigger the return;
2. The impact on returns on dividends reinvested is quite staggering.

Incidentally, it also justifies the long-term nature of Equity Investment and, as Warren Buffet succinctly put it: *'Our favorite holding period is forever'*.

Equities excellent long-term value

Whilst the UK 10-year Gilts have record low yields, so Corporate Bond yields have also fallen back from over 7% for triple-B rated to around 3%. This is less than UK dividend yields. With cheap funding for corporate, more share buy-backs or a rise in acquisition activity are both a possibility.

Conclusion

There has been plenty written about the recession, and although growth will revert to norm, it will take time. Equity markets are a good indicator of where the economy is heading, and believe the risk is on the upside. Many pension funds that have bought gilts to ensure the future liabilities are matched have actually had to buy more as a result of quantitative easing. When that unravels there could be a stampede into the high yielding equity markets. With a large and active hedge fund community that actually shorts stock, any strong move into equities could provide a bigger upside than just your average correction. The evidence to BUY UK Equities is compelling.

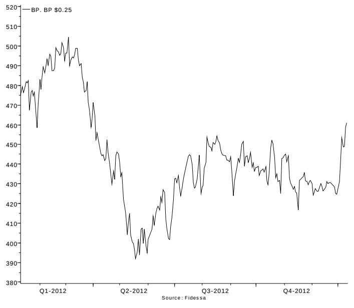
HB Markets' Stock Pick for 2013

BP

Key Data

Ticker:	BP.L
Sector:	Oil & Gas
Market:	FTSE 100
Market Cap:	£83.6bn
Price:	436.85p
12 month High/Low:	504p/391p
Yield:	4.83%
P/E:	7.4x

Share price performance

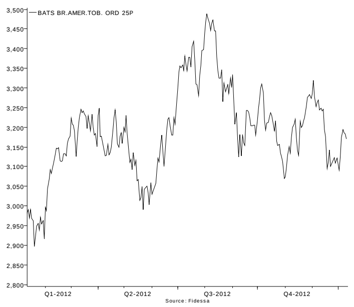


Following the much publicised Deepwater Horizon disaster, BP has undergone a radical restructuring. Initially targeting divestments of $38bn by end of 2013, the company has virtually achieved that a year early. Add in the sale of TNK-BP to Rosneft (by end of 2nd quarter 2013) and the total divestment rises to $65bn. The focus now is away from downstream (sale of refineries) to focus on upstream – exploration and production. The strategy of 'Shrink-to-Growth' is now firmly focused on the 'growth' aspect, and although this will take time, there is the potential to re-rate via a change in both sentiment and perception of the 'New BP' and in anticipation of the future growth. **BUY** inexpensive, potential recovery play, good yield, potential buy backs after Deepwater settlement.

British and American Tobacco

Key Data	
Ticker:	BATS.L
Sector:	Tobacco
Market:	FTSE 100
Market Cap:	£60.3bn
Price:	3,125p
12 month High/Low:	3,488p/2,897p
Yield:	4.7%
P/E:	13.8x

Share price performance

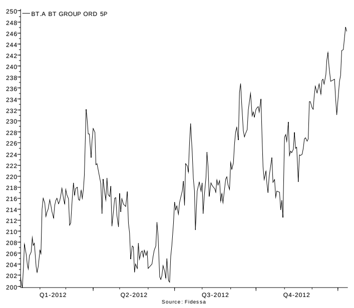


The sector price performance did not excel in 2012. A number of factors were at play in the tobacco sector, despite positive revenue, earnings and dividend growth. Notwithstanding the robustness of the sector, there is concern over increased regulation and, in particular in Australia, with the introduction of generic packaging. Sustainability of profitability has been questioned. In the face of original attacks and major liability claims, particular in the USA many years ago, BAT has not only survived but grown and believe will not only continue to grow, but with exceptional cash flow will enable share-buy backs to continue. BAT enjoys strong brands, strong management, ongoing cost savings and an enviable geographical spread, and in particular, its strong emerging markets presence. **BUY** for high dividend yield, eps (underlying) growth, share buyback and dividend growth.

BT Group

Key Data	
Ticker:	BT.A
Sector:	Telecoms
Market:	FTSE 100
Market Cap:	£18.99bn
Price:	236p
12 month High/Low:	242/190.9p
Yield:	4.6%
P/E:	9.4x

Share price performance



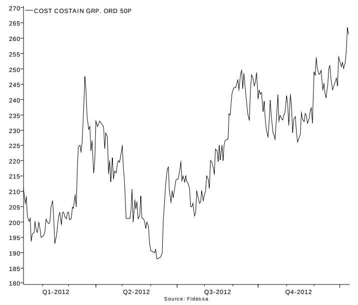
BT is a provider of communications services, serving the needs of customers in the UK and in more than 170 countries worldwide. It has four customer-facing lines of business: BT Global Services- is a managed networked IT services business, serving customers in more than 170 countries worldwide; BT Retail- provides communications products and services to the consumer market, and provides IT and communications services to small and medium-sized enterprises; BT Wholesale- provides products and services to over 1,000 communications providers in the UK; and Openreach- is responsible for the `last mile' of the UK access network and for the roll-out of super-fast broadband. Its geographic areas are: UK, Europe, Middle East and Africa, Americas and Asia Pacific. Concerns have been alleviated at recent presentations: BT is not attempting to become a TV company, but requires content to offer meaningful broadband /TV packages. BT will continue to invest in superfast broadband, YouView and content, but emphasies its growing dividend (+10%-15%) and has a strong balance sheet. Plenty of scope for cost reduction in Global Services. Superfast broadband is exceeding expectations. So, plenty of self-help improvements to come and a growing dividend. **BUY**

Costain

Key Data

Ticker:	COST.L
Sector:	Construction & Materials
Market:	FTSE Small Cap
Market Cap:	£170.8m
Price:	260.65p
12 month High/Low:	260.65p/188p
Yield:	4.5%
P/E:	9.3x

Share price performance



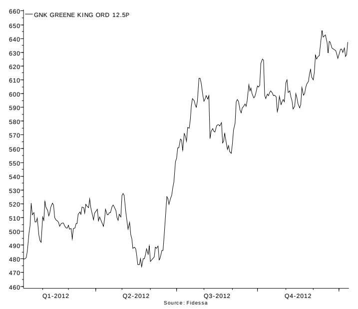
The principal activities of the group are Consultancy, Engineering, Construction and Operations and Maintenance. Its four business segments are Environment, Infrastructure, Energy & Process, and Land Development operations. Environment division comprises group's operations in the water, waste, education and retail sectors. Infrastructure division includes the Group's operations in the highways, rail and airports sectors. Energy & Process division includes group's operations in nuclear power, hydrocarbons and chemicals sectors. Land Development division is responsible for the Alcaidesa land and marina development activity in Southern Spain, a 50% joint venture with a subsidiary of Santander Bank. The January 2013 trading update maintains full year guidance and with its partnership approach and its ability to offer complex solutions, it is well positioned in the UK infrastructure market. The cash position is said to have remained strong, order book flat at £2.4bn, plus £400m at preferred bidder stage. Secured £700m work for current year, so good visibility and ahead of 2012. **BUY** for quality of the management, its growth prospects in a difficult environment and an attractive yield.

Greene King

Key Data

Ticker:	GNK.L
Sector:	Travel & Leisure
Market:	FTSE 250
Market Cap:	£1.38bn
Price:	628p
12 month High/Low:	646p/474.3p
Yield:	4.8%
P/E:	11.2x

Share price performance



A fully integrated brewer/pub operator, with over 1500 tenanted pubs and 900 managed retail pubs. Growth is important but size is not, although objective is to grow to 1100 retail pubs with a smaller higher quality tenanted estate - with due emphasis on the calibre of the Licensee. The retail growth will come from acquisitions, new builds and reverse transfers (from the tenanted estate) as well as increasing the exposure to eating out market. With a forecast yield of 4.8% makes the shares attractive. Has had a decent run but is inexpensive. **BUY**

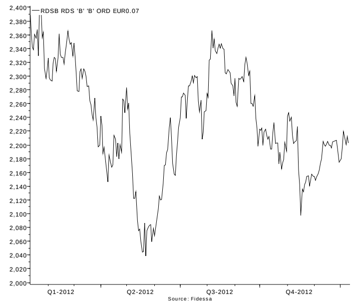
Royal Dutch Shell 'B'

Key Data

Ticker:	RDSB.L
Sector:	Oil & Gas
Market:	FTSE 100
Market Cap:	£57.47bn
Price:	2,196p
12 month High/Low:	2,489p/2,039p
Yield:	5.46%
P/E:	8.5x

Royal Dutch Shell is a world-wide Oil & Gas explorer, developer and producer. Its 'upstream' business combines the operating segments that are engaged in searching for and recovering crude oil and natural gas; the liquefaction and transportation of gas; the extraction of bitumen from oil sands that is converted into synthetic crude oil; and wind energy. Its 'downstream' business is engaged in manufacturing; distribution and marketing activities for oil products and chemicals; in alternative energy; and CO2 management. Not expensive, excellent yield. **BUY**

Share price performance



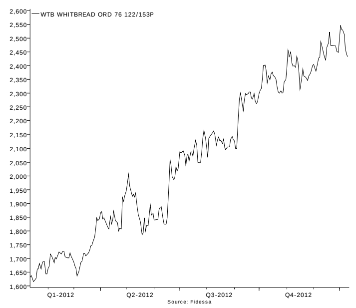
Whitbread

Key Data

Ticker:	WTB.L
Sector:	FTSE 100
Market:	Travel & Leisure
Market Cap:	£4.52bn
Price:	2,530.5p
12 month High/Low:	2,546/1,664p
Yield:	2.09%
P/E:	17.4x

The quality play in sector. Owning leading brands, including Premier Inn, Beefeater Grill, Brewers Fayre and Costa Coffee. The strong brands deliver strong like-for-like performance. Costa is the outstanding growth contributor (25% rev growth at Interims to 30 August 2012) but Hotels & Restaurants delivered excellent growth (10% revenue growth at same interims). The room pipeline in the hotels segment is 11,000. This 22% up on the near 49,000 rooms at Interim stage and on target for 65,000 rooms by 2016. The branded restaurants compliment the Premier Inn offering. Costa Coffee is an international growth story across EMEI area, and China, at 201 stores (21 cities, added 37 stores) has much potential. Buy, despite the share price performance. A well managed business and still a growth story across all the brands and geography. Management succession has been seamless. **BUY**

Share price performance



Analyst

Harry Stevenson
(t) +44 (0) 207 382 8384
(e) harry.stevenson@hbmarkets.com

Note: *All data is taken at close of business on Friday 4th January 2013*

Sources: FT.com, The Economist, Fidessa, Bloomberg, Sunday Times, Sunday Telegraph. Daily Telegraph, The Times, Evening Standard, Company Websites

Recommendations

During the three months to end-December 2012, the number of stocks on which HB Markets has published recommendations was 156, and the recommendations were as follows: Buy - 54; Speculative Buy - 78; Hold - 20; Sell - 3.

Full definitions of the recommendations used by HB Markets in its publications and their respective meanings can be found on our website here.