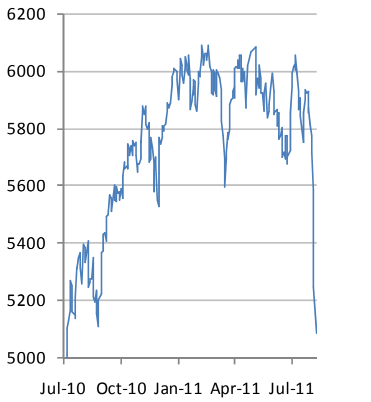
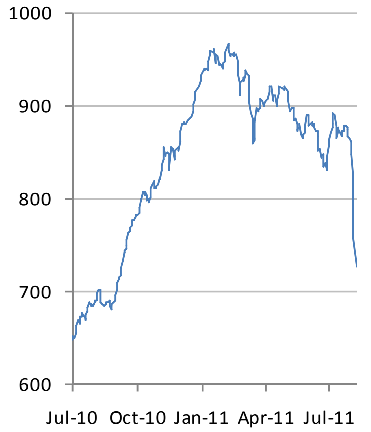
Tuesday, 9 August 2011

Market update

FTSE-100



AIM all share



GOLD (US$ per ounce)

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"The basic ideas of investing are to look at stocks as business, and use the market's fluctuations to your advantage...." Warren Buffet, 2005(1)

The question facing all of us is whether we are facing a "market fluctuation", or a structural impasse driven by the US slowdown, the de-rating of sovereign debt and the Eurozone crisis. And if it's just fluctuation, how and when do we optimise re-investment into the market? Where's the bottom in this cliff-face profile of market behaviour?

- *Full-scale risk aversion swept over markets last week. In the USA, the S&P 500 index fell 4.8% on Thursday alone, the worst day since February 2009, while at the close yesterday (Monday 8th August) the FTSE-100 had shed 14% in as little as nine working days, with a 3.4% drop on the most recent day.*

- *There is concern that the US economy has stalled, and the fact that US sovereign debt has been downgraded by Standard & Poors adds an unprecedented and unknown incremental risk. Several former Fed officials were quoted as suggesting that the chance of recession ranges from 20%-40%, with some academics putting the odds as high as 50:50.*

- *We do not envisage a US recession, though we recognise it's still a risk. Monetary policy remains very accommodative, US broad money growth has surged during July, while oil prices are back to February levels. The usual precursors of recession are not present, and it may indeed be proven that the recent weakness reflects a "soft patch" resulting from temporary setbacks such as the disruption caused by the Japanese earthquake. Some recent data, such as the latest US employment statistics, have suggested that the economy is already emerging from this soft spot.*

- *There is also, in our view, at least a 50% chance that the Federal Reserve will use its conference at Jackson Hole in Wyoming at the end of August to announce a further monetary stimulus. This would be designed to address the shortfall between actual and potential growth rates in the US economy, and though it may not be the full-blown third round of quantitative easing ("QE3") that the market talks about, any significant policy measures would be a catalyst to re-ignite the markets.*

- *The Eurozone issue is somewhat more intractable. The latest undertaking by the ECB, which now intends to buy up Eurozone government bonds to help stem the debt crisis spreading to Spain and Italy, will carry a heavy cost for France, Germany, and the northern Eurozone, and it may imply over the medium term a much larger stability fund (the "EFSF") at an unacceptable cost to the French and German taxpayers who will eventually fund it.*

- *The best hope for solving the debt crisis is that confidence is sufficiently restored to allow normal yields to return for Italian and Spanish debt, for at least as long as it takes to allow economic growth to resume. It may require a more coordinated effort by the ECB to force this to happen, but European policy-makers have surely learnt the lesson of their own recent mistakes.*

Note (1): Quotation from The Warren Buffett Way, Robert G. Hagstrom, 2nd ed. 2005

The case for equities

US policy decisions:
Between April and July last year, the FTSE-100 fell by 17.5%, and although it staged a weak and partial recovery, the month of August marked another decline of almost 5.5%. After August, it rebounded strongly, gaining around 18% by the year end, in a rally which extended well into the current year.

The difference was made by a second round of quantitative easing by the Federal Reserve, which launched a programme of bond buying worth a total of US$600bn, effectively allowing the Treasury to raise more money through debt with a guarantee that the central bank would soak up the issuance. Although this was intended primarily to allow more credit to circulate ultimately on growth-promoting investments and business expansion, in practice much of the funding flowed into speculative investments.

However, it did initially prop up the rate of growth of the US economy, which remained between 2.3% and 2.8% for the remainder of 2010, before declining again this year.

Several policy options now remain open for the Federal Reserve, and we believe it will take steps to address the shortfall in US growth soon. If it baulks at the inflationary implications of a “QE3” programme, it could take other actions to stimulate growth such as re-structuring its own balance sheet by exchanging short-term credit for longer-term debt (thereby injecting liquidity into the economy), or guaranteeing low rates over a fixed time-span to encourage investment.

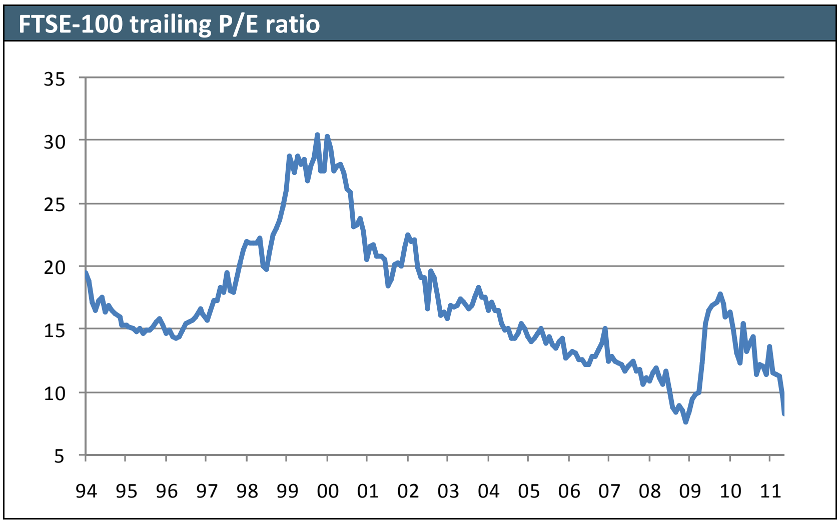
The European crisis:
A combination of policy measures may be required, but the first is surely to instil a sense of confidence that the monetary authorities have the mandate and the commitment to stay ahead of the game, rather than being dictated to by the markets.

The difficulty here is that the viability of the euro is at stake, and however satisfying this may be for some commentators in the UK, the cost to the whole of Europe of any member state having to withdraw would far exceed the cost of implementing the right policy measures. It would also create turbulence to markets far in excess of the current level, with speculation then moving against the next weakest member of the Eurozone bloc.

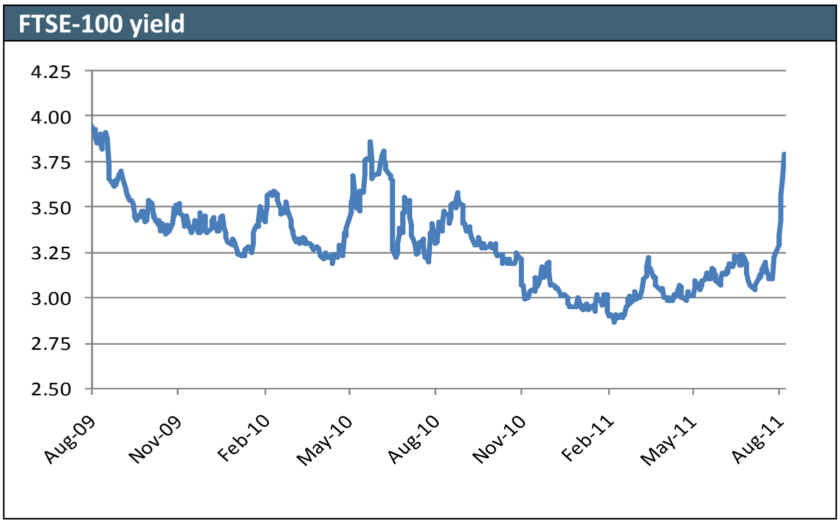
The key is to restore first confidence and then growth. We might not get all of our wish-list of lower Eurozone interest rates, a greater commitment to cover contingencies via the EFSF and the ECB, and some degree of realistic fiscal measures from key peripheral Eurozone economies, but policy is already heading in the right direction: the ECB has agreed to buy back bonds from Italy and Spain, already generating lower yields for the sovereign debt of those two countries. In addition, Italy has accelerated its programme of fiscal measures to restore a budgetary balance. A further step to validate this might be a change in the constitution of the ECB to make it a lender of the last resort, in line with the central banks of sovereign states.

Valuations of equities:
Equities are indubitably cheap both in absolute and relative terms.

As we show in the graphs on the next page, the trailing P/E ratio for the FTSE-100 now stands only a fraction above the levels seen at the trough of the credit crunch recession, notwithstanding the positive news on earnings evidenced by companies reporting their results for the half-year in July.



Although the picture is slightly less compelling on a longer-term view, it may be noted also that dividend yields are now approaching their two-year highs.



Conclusion:
We don't argue that a turnaround for equities is likely tomorrow or even necessarily the day after. We do believe, however, that the macro-economic environment is not right for a global recession, still less a further correction or – perish the thought – a crash from current levels.

Rather we suggest that the evaporation of confidence during the summer months reflects a number of very serious misgivings about policy direction on both sides of the Atlantic.

We remain of the view that these will be addressed in the coming weeks, and we envisage a year-end level for the FTSE-100 closer to 6,000 than 5,000. Given the right set of policy decisions, especially in Europe, we would posit a target of 5,800 for the FTSE-100 by the year end.

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