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Introduction

In this commentary, Simon Weighell (MPL Senior Investment Manager) outlines some of the technical investment issues facing the UK and global economies based on substantial research and meetings with key fund managers in London and Edinburgh.

Several major issues dominate thinking: the state of the UK economy – what hope for the equity markets in the current debt crisis; QE ending in the US and the effect this will have; also the sovereign debt issue in Europe, where the present state of affairs is effectively a game of 'chicken' – the ECB wants to continue deferring the issue until the most exposed Eurozone banks can deal with the inevitable default / restructuring, while the markets are looking to call that bluff on a much shorter view. I'll deal with the macro issues on a UK centric and then a global view.

UK – Debt reduction issue

- There is consensus at least that QE has ended in the UK, and that the MPC, especially Mervyn King, is correct in its cautious stance on inflation.
- Most inflation is externally derived, i.e., fuel, raw material prices and the like, and will not be reduced by higher interest rates other than by demand destruction brought about by said higher rates.
- Internal inflation driven by personal tax hikes, VAT increases and the like will drop off the inflation register in early 2012.
- A deflationary force in the economy is consumer uncertainty – local authorities and the like intending to make redundancies have to effectively put around half their workforces on notice of intended redundancy, even if the overall effort is to only target around 10% or so of the workforce – this to comply with labour legislation.
- There are knock-on effects in the wider economy and consumers are shying away from longer term big ticket purchases, especially housing commitments.

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- Higher food and energy prices are also causing negative consumer sentiment, and unsettling markets – many UK corporates are issuing perhaps overly bearish outlook statements given this uncertainty, and creating a false market mood.
- Consensus is that despite these headwinds, the UK will avoid double-dip, the coalition will hold together, and there is no threat to UK AAA status.
- The BoE and MPC suffer no credibility gap – 10yr gilts yield around 3.5% while inflation comes in at 4.0%, making for negative real yields of 0.5%; thus on a short term view at least, the BoE has credibility sufficient to encourage investors to pay the government to invest with it.
- Inflation will persist, driven by outside forces beyond MPC control.
- Growth will be slow at around 1.-1.5% for 2011, latest inflation report suggests 1.7% growth for the year, but be prepared for a further downgrade as the working population has only just received the first pay-packet reflecting tax increases; the full effect of benefit reductions, tax increases, tax threshold reductions and spending cuts will not be felt until later this year, and for this reason King is exactly right to hold off raising rates for now.
- BoE talks of first rate rise in Q4 this year – in light of the above, even that must be considered risky – most analysts and economists we have spoken with are adamant there should be no UK rate rise in calendar year 2011
- At best 2012 growth may meet trend growth of 2.25-2.5%, given the continuing difficult economic backdrop.
- Continuing growth in the emerging and other markets will continue to drive energy prices higher, not helped by the government's tax on UK energy plays – BG/Centrica have warned of 15-20% price increases in the coming months, thus inflation may stay higher for longer and this is the key concern for the MPC, especially Andrew Sentance, although the latter stands down in the summer.
- This coupled with energy price increases led by the outside world will lead to what one manager terms 'slugflation'...
- Some positive news on inflation would help, but outlook from King in the Quarterly Inflation Report is bleak, thus this will prove a notably sub-par recovery in the UK.
- Raising rates and expectations too soon will cause a sterling rally and potentially choke off the current strength of the export sector, the one positive area in the UK economy.
- The UK investment market has in the past punched way above its weight in global markets – this was in part due to the predominance of the income culture in this country, itself driven by the relatively mature pension sector and savings culture. In 1995 UK corporates accounted for around 7% of global stocks yielding above 3%, now that figure is circa 2%. As populations abroad grow both in age and sophistication, the rise of an income culture and income orientated products will increase, and already we are actively looking at overseas income opportunities. Asian, US and global income funds will come to the fore.
- The UK banks remain in poor shape, with further deleveraging to run and write offs to follow.

The Positives for the UK

- In all periods where government has reduced itself as a percentage of total output, the economy generally and the markets specifically have always recovered over time.
- Monetary policy remains highly supportive to say the least, and will remain so even after several rate rises by 2013
- BoE was founded in 1694 and rates were never before as low as 0.5%. Households here, in the US and elsewhere continue deleveraging, and need to – there is much more to go.
- Many households have benefitted from the recession – where earners have kept jobs they have seen real wages increase due to low interest rates, at least where variable rate and tracker mortgages are concerned. Same is true in the US.
- Investors need to separate the economy (GDP) and the market (capitalisation) – the latter does not necessarily need to reflect the former – this applies as much to the US and Europe as it does to the UK. Stronger GDP will likely follow the market's lead.
- Circa 68-70% of FTSE100 earnings are derived overseas, in the US, the figure is approx. 58% for the S&P 500, a surprisingly high number.
- Income and defensive sectors will do better as the markets normalise – therefore we are recommending a good mix of defensive and higher growth sectors.
- There is broad agreement that so-called 'Supertanker Funds' in the equity income sector may well continue to struggle .

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- Market performance has been mildly positive this year – the FTSE has at the time of writing crossed the 6000 barrier some 18 times this year – an avalanche of seriously negative events around the world has failed to drive the markets down below the level of December 2010...
- It is accepted that there is likely a wall of money waiting to access the UK market, but in need of a so far elusive catalyst to drive that access...this would be a rational explanation for the market's volatile but range-bound behaviour thus far this year.
- UK exporters continue to do well, although this sector is too small to drive the overall economy.
- Housing market appears to have stabilised, which is positive, but some forecasters are calling for a c10% further fall in 2011/12 – this may not happen but the forecasts nevertheless destabilise sentiment.
- Despite comments about globalising income above, UK income funds will do better as value stocks have inevitably lagged the momentum plays in the form of the miners, energy and industrials. Thus UK equity income plays continue to form part of our strategy, alongside the more international income and growth areas.
- The UK macro outlook, whilst not particularly attractive, has at least stopped deteriorating, and double dip recession is now widely considered unlikely. None of the ten or so managers and economists we have spoken with are seriously predicting this. Taking a longer term view, the time to commit to a market is when the deterioration has stopped, as when the good times are widely perceived as returning, the major rises will have been missed, and this should form a central plank of any strategic message to clients.
- The current cycle will be much longer than normal, perhaps a 4-5 year recovery phase, reflecting the headwinds facing the economy.
- Supporting this is a UK market on circa 10x forecast 1 year earnings, falling to c9.5x forecast 2 years – these are undemanding multiples, and as the global economy returns to shape, there is the possibility that the highly internationalised UK market will benefit.
- Equities offer an inflation-resistant investment approach as long as the rate of that inflation is contained – as this appears likely in the UK, so equities offer that additional attractiveness.
- M&A is currently at historic low levels – this will improve, but only with time, as recent trauma in the form of Pru's abortive approach for AIA and three rebuffed approaches from BHP have left the market uncertain of the political and shareholder reception to major M&A. BHP, having written off near $1bn on the failed approaches, has now ruled itself out of major acquisitions, and it is unlikely CEO Kloppers would survive a further failed attempt. 'Resource Nationalism' will likely make large scale M&A in the resources sector a difficult and potentially expensive game to play, and this in turn will have the effect of further slowing the needed supply increase of key raw materials to the markets.
- The UK index has a large and internationally incomparable commodity exposure – approx 30% of the FTSE 100 is oils and mining, increasing to about a third of the index if one includes key supplier / service providers to these sectors. Both the China and Japan stories are positive for these sectors in the medium to long term. Japan will be negative short term as power shortages and supply chain problems disrupt normal patterns, but the reconstruction effort will require resources and may even succeed in generating a bit of inflation in that economy.
- M&A will happen in the resource sector, but perhaps mainly as 'bolt-ons' by the major diversifieds. Rio's acquisition of Riverside was a case in point although at $4bn it was a large bolt-on, even in the context of Rio's current £63bn market cap.
- UK industrials have significant exposure to Global Emerging Markets (GEMS), and will benefit from growth there. Raising rates too fast may lessen Sterling's advantage versus the Euro and weaken UK manufacturing, hence King's unease at the 4-way split on the MPC.
- Analysts and fund managers appear on the surface to be united in stating that while the markets may well have a reasonably substantial 'wobble' at the likely ending of QE at end June, they are not seeing scope for a major and sustained correction in the equity markets after that, in the absence of any further disaster, cataclysm etc.
- But given the amount of uncertainty, most analysts and managers are playing their hands quite cautiously, but nevertheless most are at the same time relatively fully invested.

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The Global Economy Faces Headwinds...

- There is much deleveraging across the globe. But focused on the Western economies where growth is very slow.
- Energy prices have risen – arguably too high and too fast, much market speculation is evident. Global markets can probably cope with a dollar a month increase in the oil price- from a base of circa $110 Brent. Elevated and sustained oil prices will inevitably lead to demand destruction; there is evidence of this in the US where gas prices above $4 tend to destroy demand; as we move into the driving season there, we will monitor the effects.
- Thus the commodity correction seen in recent days, especially in the energy space, is a positive for the markets, as long as the oil price does not continually tick up at too fast a pace.
- This demand growth in the energy sector will drive inflation in the West, and lead to the slugflation argument.
- UK inflation has been above target for 50 of last 60 months - will remain so for some time yet, creating ongoing demand for 'linkers' (index-linked gilts).
- UK inflation has yet to peak – peak RPI perhaps around 6% in July/August 2011, increases chances of policy error
- We are entering the end of the deflationary period of developing world interaction with the G20.
- From now on, we compete head on for scarce resources, and many emerging markets have the capital reserves to bid up resource prices.
- Inflation in the G20 may be far more systemic from now on – makes bonds more vulnerable, increases attractions of both equities and linkers.
- Many GEMS will experience currency appreciation, partly to alleviate higher input costs, thus we may well be importing their inflation in due course.
- Singapore Central Bank has stated U$ peg range to be eased, while Wen Jiabao of China now openly talks of currency appreciation to contain import costs – Renminbi convertability later this decade?!? Some predict this by 2016-17, unlikely.
- There is a danger in the GEMS that higher food / resource costs will lead to wage-pull inflation, there is additional chance that the same could drive wage pull inflation in the developed world.
- 20 GEMS have already tightened rates, with China this year having moved several times and substantially raised bank reserve requirements, five moves so far this year.
- Food price inflation is endemic – while this has inflationary consequences in the developed world, the effect in the GEMS is much more marked, where consumers in poorer states spend the bulk of their incomes on food. Lest we forget, the Tunisian market stall trader whose self-immolation sparked off riots across the MENA region was motivated to his suicidal protest by rising food prices.
- The vast majority of Chinese are still poor and will be affected by higher prices.
- Many emerging market states continue to subsidise food and fuel – sometimes heavily – to ward off social unrest; question is how long can they sustain this?
- Global grain inventories are at multi-year lows, a fact unlikely to be helped in the short term by unpredictable and destructive weather patterns. There exists a substantial and urgent need to expand food production, hence our interest in global agriculture funds.
- US has largely expended its ammunition store – last option left is QEIII and this is not seen as helpful for global markets.
- The recent warning shot by S&P on US credit ratings was probably intended as a sign that markets may not tolerate QEIII, at least not for long.
- Interest rates are unsustainably low – rates have only one direction from here, with rising rates set to distort the carry trade, potentially disrupting it as the cost of carry goes from virtually nothing to something more reasonable – this will likely be destabilising in the short term, but in the medium to longer term may serve to reduce volatility by removing some speculators from the market.
- Bond markets, particularly sovereigns, are not seen as offering value at the moment. Arguably they are over-owned which is hardly surprising given recent and current issuance. Demand remains high as particularly the major institutions are long on bonds as they continue with a cautious approach...
- However, trend-setter PIMCO is now reportedly short of circa $10bn worth of US T-Bills; PIMCO must be seen as lead indicator here. US T-Bill rates must inevitably rise, thus there is considerable incentive for Capital Hill to control the budget and rein in the deficit, yet internecine warfare on Capitol Hill, the rise of the Tea Party and Obama's loss of Congressional control hardly helps engender confidence in the US's ability to get to grips with its funding issues.

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- By the time of the next US financial crisis, the Greenback will be one of two or possibly three global reserve currencies – it will not be able to print fiat money and rely on overseas players to buy it, except at elevated yields, therefore in the next crisis it is on its own. Currently USA is c24% of global GDP but U$ is 60% of global reserves – this is unsustainable and explains why China effectively now backs the Euro - currency speculators beware.
- In Europe, the sovereign debt crisis has hogged the headlines with a vengeance – I was asked at a lunch what my view was on Europe - it is that we now know and must accept that Greece and Ireland 'are toast' as one manager put it, despite all the EU protestations to the contrary. Greece must either restructure its debt or default; the latter option appears to be politically unacceptable, thus a Eurozone managed debt restructuring appears to be the most likely scenario, and German noises to this effect appear to support the view that this is increasingly the direction in which matters are progressing. Greece has already announced that it is unable to meet the terms of the original bail-out plan. This restructuring will likely occur in 2012, or early 2013.
- The 'haircuts' being discussed are in the order of 50%, so a serious issue for holders of the debt. The fact that Germany is pushing the issue forward reflects both a belief that core Eurozone electorates are no longer prepared to support open-ended bailouts (witness recent German state election results and the rise of the True Finn Party.
- Note that the new European Stability Mechanism due to start in mid-2013 is designed to ensure Euro stability and is subject to strict conditionality. Including that future bail-outs will be given only to solvent Eurozone members – I interpret that as a German inspired input to ensure that there will no future open-ended bail-outs, and that future aid will effectively be conditional on prior restructurings.
- This in turn implies German banks are probably 'off the hook' sufficiently in terms of their CDS exposure to Greek sovereign debt by mid to late 2012 to be able to cope with a Greek default without destabilising the German banking system / economy. Thus the tin appears to have been kicked down the road far enough to allow for a Greek (and afterwards Irish restructuring) whilst not toppling the Eurozone banking system.
- No coincidence that the last major years of CDS issuance would have been 2007/8, and with 5 year lives these will be expiring 2012-13.
- Which means Greece must default or restructure prior to June 2013, and that means bond holders share the pain, as above, of haircuts around the 50% level. In the meantime and to keep 'kicking the tin down the road', Greece will require more bail-out funds under the existing European Financial Stability Facility, due to close in 2013.
- US housing is and remains a disaster area – nationally, negative equity affects circa 26% of all households, in select parts of the rustbelt such as Detroit the figure is estimated over 50%. This is hampering one of the long term drivers of the American growth model – labour mobility, as people with negeq are effectively tied to their property or must default.
- Housing surplus stock variously estimated between 12-18 months' supply, prices nationally are predicted to fall a further 11-15%, thus the recovery in the US will not be led by this sector. So this recovery has to be different from every other post-war recovery; at present it appears a new capex cycle will lead the recovery, followed by export sector and a still strong part of the consumer population.
- Once QE is ended and uncertainty removed, US financial markets may innovate a solution to the housing mess - perhaps a new breed of residential REIT offering reasonable rents to the housing dispossessed.
- Global earnings growth may be peaking now and for the remainder of this year, in which case growth figures may roll over in the short term, but the operative point here is that equity market valuations already do not reflect the underlying picture, and that is one where corporates, here in the UK, on the Continent, in the US, and in the GEMS, are generally in rude health and are decidedly cash rich.

But....Opportunities Remain in the UK, Europe, GEMS, and the US

- Swiss Life is reportedly pleased to be holding only 2% in equities across its portfolios...Eurozone financial institutions now hold on average 6% of their total financial assets in equities...which are therefore arguably under-owned, and in turn implies that this round of institutional selling has reached its end, or nearly so. Eurozone equity exposure is perhaps one third of its 1998-2000 level, which was arguably distorted upwards by the TMT issue, but there is scope for this to increase from current levels.
- The Eurozone equity risk premium (ERP) is currently around 9%, and stands out even from the US's 6% and Japanese equity market's 7%. We have to go back to the 1950's to see this type of sustained ERP when equities

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out-yielded short sovereigns. With Eurozone earnings likely growing around 15-17% this year, with similar figures due in the US, the sovereign debt issues are masking a quite positive underlying story, and we remain positive on Continental and US equities. VW for example currently has a €20 billion order book and yet trades on around 0.4x forward sales, price/book of 1.1x, trailing per 6.86x.

- We need to make the point that while Europe is undeniably extremely badly managed, Euro corporates are not, and governance standards are generally as high as their US counterparts; again, we need to separate the Eurozone and its stock indices.
- GEMS continue to grow at rates of 4-9%, given that they already account for over 50% of global GDP, over 50% of energy demand and practically 100% of energy / materials demand growth at this time, global growth is still projected by the IMF as of now to be in the region of 4.25-4.50% for calendar 2011, and probably circa 5% plus in 2012.
- But...ending of QE in the US (June 30?) would be positive; firstly it will stop the printing presses – much as predicted, when the presses roll in a sluggish US economy, much of this fiat money ends up in emerging market (that is, higher return) economies – the Brazilians and the Chinese have expressed exasperation at this and the need to take defensive measures such as currency controls, taxes and other measures to prevent property bubbles. Thus the ending of QE may allow some loosening of monetary policy in select GEMS or at least forestall further tightening. Secondly, the current veil of uncertainty re QE will be removed and confidence levels in the West will increase, the ending of QE potentially seen as a vote of confidence in the US economy being once again able to stand without the QE prop.
- A stronger US without QE will in turn support the Dollar, and this will cause ripples in wider markets, including commodities and GEMS. In the former, nothing in terms of the supply/demand story has changed, but arguably dollar strength expectations are holding back the commodities plays at present. Anticipate GEMS monetary loosening post QE end would compensate for $ strength impact on the commodities complex.
- U$ shorts are starting to unwind – this is a positive. But note recent commodities shake-out largely triggered by major increases in margin requirements in silver, gold and oil markets – this may drive down speculative activity, again a positive.
- It is important to ask where the tightening cycle in the GEMS is going – China and others have probably already done enough to rein in lending, effects lag the increased rates and reserve requirements, and it is therefore likely that the tightening cycle will end within two months, else they risk derailing the growth story.
- Couple that with the likely scenario wherein QE in the US ceases from end June – also around 2 months from now – and the scene is potentially set for a widespread recognition of an end to easing or even some slight loosening of policy in the GEMS from that point. If the US and European growth stories appears intact simultaneously, then the markets could move significantly to the upside.
- In Europe, Germany has produced strong Q1 growth of 1.5%, beating forecasts; no surprise there given record German export levels and values, but perhaps more surprising was France's 1% Q1 growth. Note well that this is based predominantly on an increase in investment spending by French corporates and some strength on the part of the consumer. We may have reached an inflection point here – when corporates initiate the capex round it would be wise not to be short on the equity markets, and hedge funds either short or thinking of shorting may do well to note this.
- As of earlier this week, S&P companies reporting this season had seen a 79% meet or beat level, further enhancing corporate profiles.
- Globally, Free Cash Flow yields are generally running well ahead of dividend yields, thus there is scope for improvement in the latter.
- In the US, temporary hirings are running ahead – temp agencies are growing at c17-20% yoy – this has in the past provided a strong lead indicator for permanent employment increases. Initial claims data supports this view, although there remains a great deal of mistrust in the US recovery story. We believe in it and hence US funds are on the active buy lists.
- US per expansion will follow the ending of QE and the start of the monetary normalisation process. As corporate America 'could not be in better shape' (Felix Wintle) this normalisation process is due to commence.
- US productivity growth is rolling over due to a prolonged lack of capex spend – Corporate America is now long overdue its next capex, hiring and tech round – which is what will drive future productivity gains.
- US markets are heavily exposed to overseas growth story – especially tech, energy, oilfield services and industrial sectors. Many US players have pricing power given relative lack of specialised capacity across the globe, with little new productive capacity due on stream in the near term.

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- Technology and energy plays will likely be key drivers of the S&P towards 1400 level.
- US commercial property spending may increase form here given lack of output in recent years.
- In Europe, M&A deals as a percentage of overall market cap currently runs at around 2%, versus an average c5% since 1985 – M&A will likely increase from here.
- The Glencore IPO has reportedly attracted interest at twice the available stock level- will provide an important litmus test for the markets, both commodity and IPO.
- UK banks – or Lloyds at least – may be dividend payers by 2013. This will be tied into the political cycle, where the coalition will be anxious to get these at least partly privatised before the next general election; dividend yielders will be more attractive to income-hungry investors.
- PMIs across most DM and GEMS remain in positive territory, pointing to sustained growth...
- GEMS growth is arguably too strong - there is a case for saying that a recovering DM combined with strongly growing GEMS will cause substantial imbalances in the commodity supply / demand area. Supply response severely derailed by financial crisis of 2008-2010.

Conclusion:

- By any measure, US, UK and Eurozone equities are and remain cheap; bonds offer some value, sovereigns little value.
- Whilst DM equities have been left behind by GEMS markets, the latter still offer solid long term value as demographic and economic forces dictate long term outcomes.
- Cyclically, the developed markets appear remarkably undervalued.
- Structurally, unprecedented headwinds remain, principally the ending of QE, a financial control experiment the likes of which the world has not previously seen, and the Eurozone Sovereign debt issues, which by definition have not been seen before.
- Growth will roll over to a degree as with PMIs at up to 60 and beyond it is difficult to beat that, but markets do not yet reflect good corporate news we have already had.
- Capex and M&A expectations are increasing. US M&A may reach high levels as year wears on.
- The majority of today's market players are motivated to act primarily with a view to a 6 month outcome. With the coming 6 months appearing murky at best, most players are sitting on the sidelines as far as equity purchases are concerned.
- Markets will grind higher but possibly intense short term noise will increase volatility.
- Hedge funds are back in terms both of number and FUM – be prepared for the return of volatility.
- Longer term investors are 'hiding out somewhere' as an analyst put it, in terms of maintaining and /or increasing bond positions, afraid of committing to the equity markets, hence continuing low bond yields.
- But...sovereign bonds offer very little value, and are vulnerable to inflation, yet yields remain stubbornly low – this is a dangerous game. Many high grade corporates are now purely yield plays, no capital upside.
- There is still value in corporate bonds, especially in the higher yielding areas and in GEMS sovereigns/corporates. High yield default rate is low and lower than implied by the spread. Spreads will narrow, particularly BB/BBB versus higher investment grade. The multi-year bond bull market is nearing its end.
- We do not want to see commodity prices at too high levels = demand destruction. No consumer boom as along as oil price remains elevated.
- Gold is still attractive, but value lies principally in the mining stocks now, rather than in the physical commodity.
- Commodity stocks remain inexpensive on forward earnings, BHP on 8x and RTZ on 7x, etc. Either commodity prices and/or volumes collapse, or the market needs to re-rate this sector. Need for selectivity with commodities.
- Current cost-push inflation could easily from here turn into demand-pull inflation.
- Scope for policy error both in UK and elsewhere remains high – did ECB move too soon? Trichet retires in a few months = difference??
- The UK will be a less important world market than previously, saved by its significant internationalist exposure. The UK population is 0.9% of the global population, with economic power and influence increasingly shifting to Asian population centres.

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- UK recovery will be much weaker than elsewhere in the G7/G20.
- We must invest internationally to capture growth potential – there is some currency risk although we expect the Dollar to rally from here.
- Volatility will intensify from here – VIX currently c16x, this level will likely double and remain there for a period – then falling back to long term trend levels of low twenties.
- We in G7 are no longer the centre of the world – one analyst suggests Brazil's BOVESPA exchange acquires the Madrid exchange, the latter being far cheaper than the former...
- There is a wall of money awaiting positive signals to access global markets, including the UK – if and when these signals materialise, markets may move fast – we need largely to be where we want to be positioned in advance of that, as we cannot move as fast as other market participants, especially larger institutions and hedge funds. We need to communicate this to clients on an ongoing basis.
- There will be lots of short term noise, need to stay focused on the big picture.
- ***While there are many serious market positives, this is not a time for unbridled bullishness; chances of policy error remain high, and we are entering a process of exiting unprecedented financial experiments, with a fragile banking system. The coming weeks will be volatile, but we must believe in our strategy, keep calm and carry on.***
- ***We live in very interesting times..........***

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