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Strategy Outlook

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Editorial



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Economic and Strategy Outlook

The end of the beginning...

The first stage in what is likely to be a long haul out of the post Lehman's crisis is drawing to a close, not altogether unsuccessfully. Revolutionary policy stimulus (both fiscal and monetary) on a scale not seen in fifty years succeeded, for the most part, in reinvigorating economic growth, stabilising global trade and triggering a massive rebound in financial markets. The challenge in the next stage will be to see if the stimulus applied has real durability, or whether – as soon as policy makers start to withdraw parts of the program, by cutting spending or reversing quantitative easing ('QE') – we slip back, Japanese style, into near zero deflationary growth.

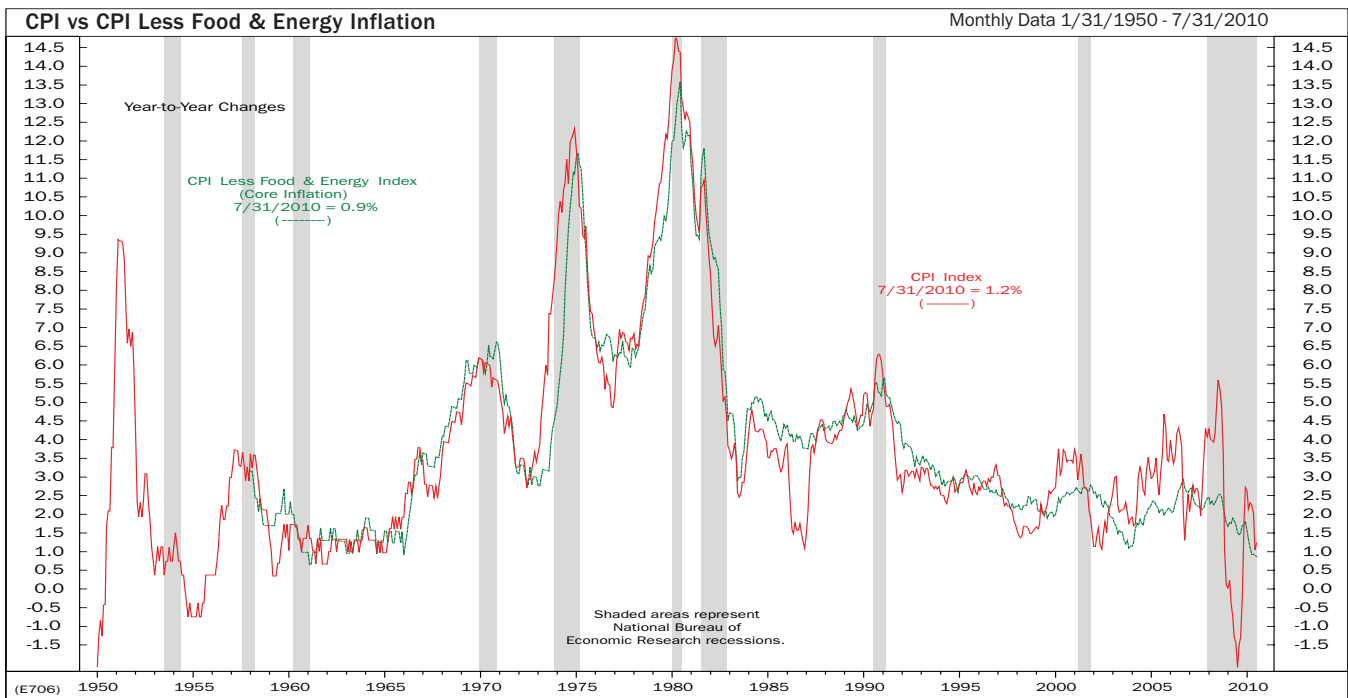
To date, where governments have 'tested the waters' and cut programs, the results have been decidedly mixed, and it is this uncertainty (among businessmen, economists and politicians alike) that is driving investors into the arms of the government bond markets, and condemning even the very best of our 'Nifty Fifty' blue-chip equities into a frustrating market trading range, seemingly regardless of the quality of earnings or dividends they produce. My hunch is that this won't last for much longer but investors will need to be patient – either economic growth stabilises,

bond yields normalise and stocks rally, or else central banks release more liquidity, yields fall further and ultimately investors buy blue-chip stocks for their balance sheet strength and yield. In the meanwhile sit back, be patient over these low volume summer months, and enjoy the unusually strong cashflow and dividend growth of our thematic, global 'Nifty Fifty.'

Back to the future...with more global 'QE' from nervous central banks

With fiscal policy largely exhausted and politically difficult, policy makers have experimented by kicking away a few monetary crutches across the world economy, with decidedly mixed results. For example, the end of Switzerland's expensive and ambitious intervention programme to hold down the franc has seen the currency back close to its all-time highs against the euro. In Europe, at the height of the Greek crisis in May the European Central Bank (ECB) was forced to relent and take lower quality sovereign debt onto its balance sheet, breaking a commitment not to directly intervene in bond markets (indeed, there were rumours that the ECB was recently an active purchaser of Irish bonds). By contrast, the expiry of central bank gilt purchases in the UK did not see bonds collapse as many, including ourselves,

Chart 1: 21 year lows for core US inflation make veteran deflation fighters like Chairman Bernanke nervous



Source: Ned Davis, August 2010

suspected they might (perhaps the new chancellor's spending cuts comforted markets more than 'QE'); foreign central banks and institutions largely made up the difference.

Core inflation in the US at a near fifty year low (see Chart 1), is troubling for a central bank chairman determined to avoid deflation; indeed he built his academic career on advice to avoid just such an outcome. Interestingly, just prior to the about-face on treasury purchases by the FOMC (Federal Open Market Committee) last week, James Bullard, the St. Louis Federal Reserve Bank President, released an academic paper extolling the virtues of more unconventional money policy. He writes:

"The global economy continues to recover from the very sharp recession of 2008 and 2009. During the recovery, the US economy is susceptible to negative shocks which may dampen inflation expectations. This could possibly push the economy into an unintended, low nominal interest rate steady state. Escape from such an

outcome is problematic. Of course, we can hope that we do not encounter such shocks, and that further recovery turns out to be robust - but hope is not a strategy. The US is closer to a Japanese-style outcome today than at anytime in recent history."

Source: St Louis Federal Reserve Bank, July 2010

Bullard argues that the Federal Reserve should use further aggressive purchases of Treasuries (instead of committing to keeping interest rates low for an extended period of time) to combat low and declining inflation expectations. While only time will tell whether Bullard's views will sway the remainder of the FOMC, we can be sure that the debate within the Federal Reserve will be about how best to deploy their limited arsenal and create new ammunition to give the economy sufficient escape velocity from jaws of deflation.

With a slower economy in the US and China and fiscal austerity at home, inflationary pressures in the euro area are unlikely to emerge, making the ECB exit strategy from its loose monetary policy unlikely before

mid-2011. And, despite the success of the EU stress tests in restoring confidence in the European banks, the ECB will have to continue to provide them with ample liquidity, as the wholesale market (where they access short-term funding) remains closed. Finally, further support to the euro area member states through additional purchase of government bonds will also take place (see Chart 2 for Federal Reserve and ECB liquidity).

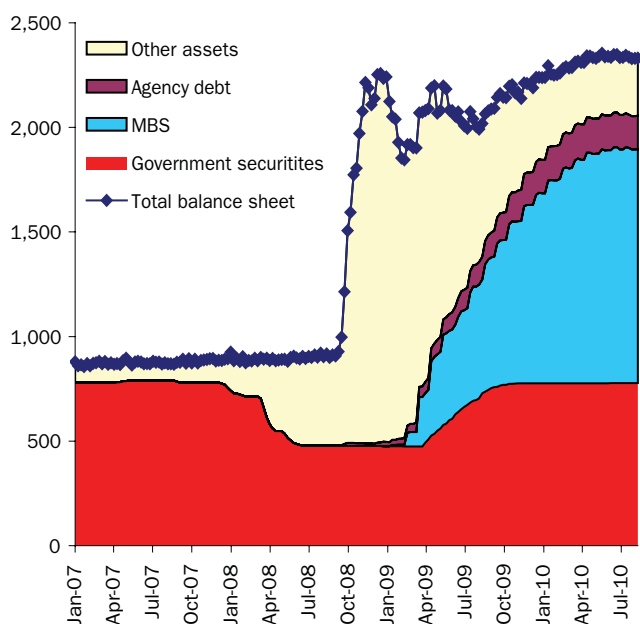
In Japan, too, Economics Minister Satoshi Arai states that the government needs to work with the Bank of Japan (BOJ) to respond to the sharp rise in the yen against the dollar (could this mean intervention?). He added that the government was in discussions with the BOJ on the yen rise, and he would be monitoring its potential prevention of a self-sustaining economic recovery. Another global candidate for an imminent 'QE' program.

Corporate optimism meets economic despair...

The irony of this economic uncertainty is that it is difficult to find it reflected in what

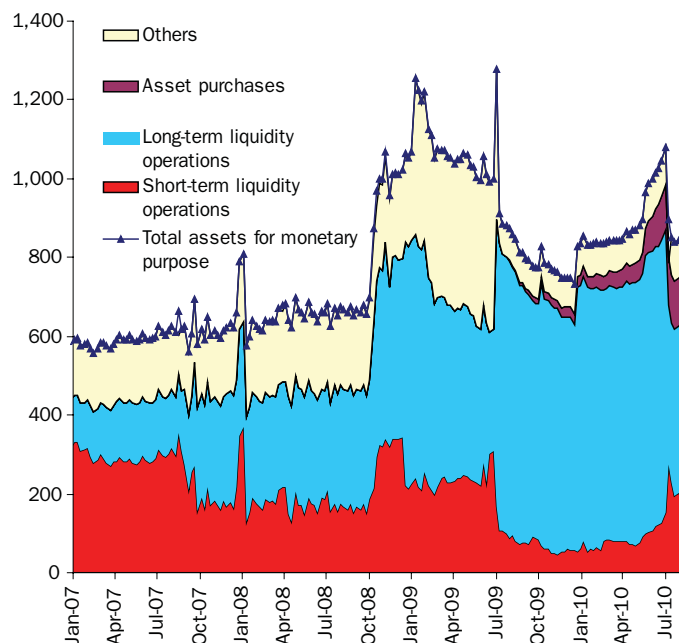
Chart 2: Central banks' balance sheets are not going to be reduced anytime soon...and ample liquidity ultimately means higher asset prices

Federal Reserve balance sheets (USD bn)



Source: Federal Reserve, August 2010

ECB balance sheets (EUR bn)



Source: Datastream, August 2010

appears to be an increasingly upbeat corporate world. Corporate earnings remain extraordinarily robust (up 37% this quarter in the US, with a near record 75% of companies beating estimates), with similar trends across all major markets. Meanwhile, despite a mountain of negative sentiment, global growth seems to be just about holding steady; last month, the IMF upgraded activity for this year from 4.2 to 4.6%, which seems to be ample for cash-rich, extraordinarily lean global blue chips. Yes, the forward looking ISM index has started to roll over and US inventory levels are creeping higher, but our analysts are still seeing material thematic opportunities in global companies *almost regardless of the economic backdrop*. Below I have taken just a few examples:

Nissan Motor reported its strongest quarterly operating profit in more than two years this month, as sales rose sharply in China and other major markets. The company sold a total of 954,000 vehicles in the first quarter of fiscal year 2010, which is an increase of 32% compared to the same period last year. Carlos Ghosn,

president and CEO of Nissan, said: "First quarter results for Nissan are good and our recovery is vigorous and ahead of schedule", supported by Nissan's position in emerging auto markets, its expertise in smaller vehicles and a leading position in next generation electric cars, which provide rich future possibilities for the company.

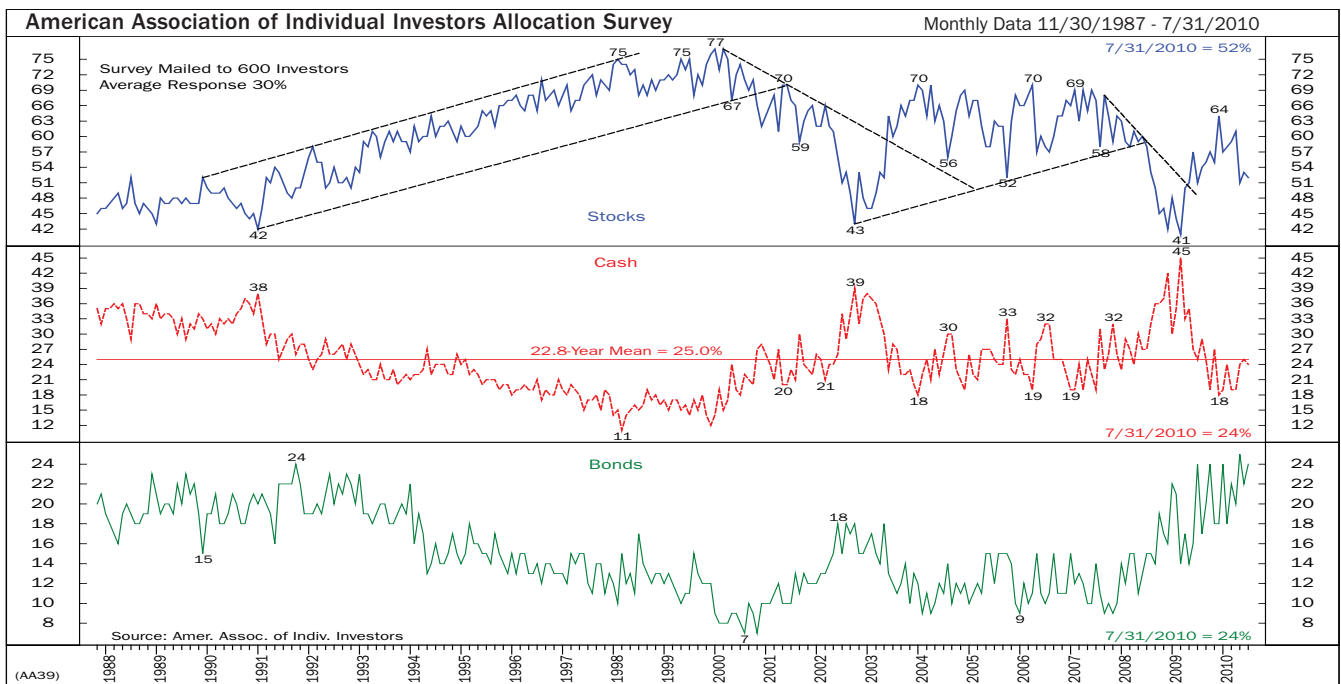
Meanwhile, the potential for rapid factory automation in China is clear, supported by both rising wages and manufacturers aiming to move up the value chain to produce higher quality goods. This long-term thematic growth is being captured by **Fanuc**, Japan's leading robotics company. The Nikkei newspaper has reported that the company plans to increase its monthly output of robots by 70% by this autumn, to a record 2,500 units. Mitsubishi UFJ Securities forecasts that Fanuc's sales to the rest of Asia will grow by 350% in second quarter of this financial year.

Sales of **Android** (the mobile operating system from **Google**) based smartphones have grown from 20,000 per day in 2009 to 200,000 per day in July 2010 as the

technology has captured mainstream consciousness and given consumers a genuine alternative to the iPhone. The shift from traditional mobile phones to these high-end, touchscreen handsets is occurring irrespective of the moribund economic environment. We invest in this parabolic growth story via **HTC**, the Taiwanese smartphone maker; sales of their powerful, irreverently branded touchscreen devices have leapt in recent months as the Android phenomena goes global. HTC's revenues in July were up a remarkable 126% year-on-year, and we expect strong growth to continue. This seismic shift will have positive ramifications for data revenues, returns and profits in telecoms; a sector with enormously attractive dividend yields.

Even a traditionally cyclical stock like **AP Møller-Maersk**, which should be vulnerable to economic uncertainty, is reporting container volumes which are *now surpassing the record levels of 2008 - its Australia and Latin Americas division saw volumes up 31% last year*. We believe that AP Møller is better managed, better funded, has more efficient ships, and significantly

Chart 3: With the promise of near zero rates for an extended period, investors are switching cash to bonds and accepting the duration risk...surely the higher dividends of global blue chips are a safer alternative



Source: Ned Davis, August 2010

more experience managing through cycles than its competitors, hence its place in our thematic stock selection. More importantly, though, fundamental changes in emerging market trade flows can, we believe, deliver earnings opportunities even if global economic growth should slow.

Investment Policy

Extremely low summer trading volumes (about 50% below the five year average for the S&P 500), exaggerated by 'Quant' and computer-driven trading models, have left the market paranoid about 'macro news shocks'. Indeed, over the last three months, according to Goldman Sachs, the S&P 500 has fallen by 80bp on days when major macro data is released, and risen by an average of 32bp per day when the economic diary is clear. They calculate that such a focus on 'macro' days is unusual and occurs typically after major market shocks (1988, 2002 and in late 2008). A similar obsession with the economic downside is reflected in the 'skew' of the options market, with downside protection far more expensive

than upside participation, implying a tail-end, macro-risk mentality as the key driver of current investor sentiment. How should investors react?

1. **Government yields** found new lows following the Federal Reserve's announcement that their balance sheet will be maintained by replacing maturing securities with 2 to 10 year US Treasuries. US individual asset allocation surveys (shown in Chart 3) demonstrate near record bond fund holdings, mostly at the expense of cash, as the 'low rates for an extended period' mantra is repeated. We are still reluctant to purchase mid- and longer-dated government bonds at these yields because of the absence of convincing long-term value for clients. This certainly hurt the performance of our bond mandates in the second quarter, but still leaves us broadly ahead of benchmark for the year to date, supported by very strong returns from our emerging market holdings. We have particularly focused on the prospect of currency

appreciation in the local Asian markets, such as Korea, while the Indonesian and Philippine markets have the additional benefit of attractive yields. We also favour developed market issues from leading emerging world companies. We retain an opportunistic and value-based approach to index-linked issues globally.

2. Despite the on-going inability of peripheral European banks to fund away from the ECB, the release of the CEBS stress tests has been broadly positive for the **wider investment grade corporate debt market**. There are pockets of value, despite the generally low yield environment. Wide spreads are available within non-cyclical credits, such as transportation, blue-chip companies from peripheral Europe, subordinated utility paper, senior bank and insurance debt. Moreover, we see Basel III as supportive of bank debt at all levels of the capital structure. We expect the vast majority of banks (and insurance

companies) to call subordinated debt at the first opportunity, and there remains a likelihood of tenders for securities trading substantially below par. With many issues pessimistically priced to perpetuity, there are some excellent yield and capital appreciation opportunities available in subordinated financial paper. In other words, our credit, emerging and index-linked fixed interest teams are finding plenty of value opportunities, despite a cautious view of this extraordinary rally in long-dated government issues.

3. Investors understandably remain perplexed by the countless macro risks they hear from central bankers and the

financial press, in contrast to the consistent profitability reported by global blue chips and the comparative confidence of their CEO's. The 'macro-micro' difference described is not impossible to explain; productivity and efficiency gains still accruing from last year's cost-cutting programs and a general bias to export markets are supporting earnings, while larger companies – because of their high cash balances and access to corporate bond markets – face none of the liquidity pressures and borrowing constraints seen in the rest of the economy. Our response is be cautious on higher risk investments for a while longer, and to be patient, but also to sit back, and enjoy

the unusually strong cashflow and dividend growth of our cash-rich 'Nifty Fifty,' that we continue to hold at the heart of our thematic equity and balanced portfolios.

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