

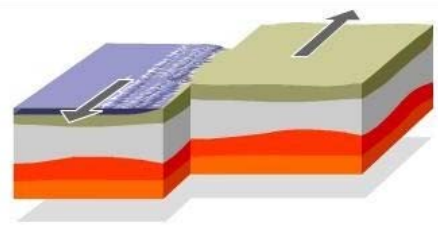
INVESTMENT NOTE

August 2011

Tectonic Plates

Expect Increased Volatility As We Move Into a new “Normal”

Corporate earnings and economic growth are not always easy bedfellows; often an increase in one precedes an increase in the other, and vice a versa. This ‘normal’ action causes both volatility and investment opportunities over time. It is not uncommon however for these two “tectonic plates” to stick, then shift violently to cause severe spikes in market volatility and value. A catalyst typically precedes such events. Following three months of seismic activity and pre-shocks we finally witnessed a huge shift this summer as the realisation dawned that economic growth was failing to keep pace with much improved corporate earnings (global credit issues a probable catalyst). Having gyrated in a broad band for much of the year, equity markets capitulated with many recording losses of 10% in less than a week. With much of the pressure having been released will markets revert to normal or can we expect further after-shocks this year?



Corporate Earnings

In the two years following the last recession companies responded to a drop in consumer spending by aggressively cutting costs and reducing the number of employees. By maintaining productivity, they were able to fully exploit the ensuing growth in consumer demand (itself induced by government stimulus) to rebuild balance sheets, reduce debt and subsequently report record profit margins – companies have never had it so good! Indeed in the US, 69% of S&P 500 component companies have reported earnings better than analysts expected, and overall earnings are up 18.9% from last year’s levels. As further proof of corporate balance sheet strength one can not ignore the multi-billion pound take over’s and mergers announced every day. With company and analyst outlooks generally positive one would have expected earnings to maintain their upward momentum for the remainder of the year. However over the last six months we have had fair warning that economic growth was becoming less supportive to this thesis than originally thought – such dichotomy resulted in the modest volatility (or pre-shocks) we experienced prior to August.

With most observers firmly focused on both the sovereign credit crisis developing in mainland Europe and the debt down grade on the other side of Atlantic, pressure grew between GDP and corporate earnings relatively unnoticed. When this pressure could no longer be contained something had to give; and ‘give’ spectacularly. As GDP growth expectations suddenly diminished, risk appetite rapidly dried up resulting in significant equity market declines with investors preferring the perceived safety of government debt (treasury yields in the US falling to record lows despite the much debated S&P downgrade) and even precious metals with gold hitting record highs.

Economic Growth

News too that growth in German GDP was hardly recordable in the second quarter (a similar situation to that of the UK) began to confirm the slower growth argument. (This additionally dims Germany’s “shining light” status within the European Union). Such a pessimistic view is equally attributable in the US where economic data is looking weaker by the day; the University of Michigan’s consumer sentiment index for August plunged to its lowest level in thirty years – let us not forget that consumption accounts for more than

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two-thirds of US economic growth. Consequently focus in Europe has shifted from sovereign credit worthiness to the credit worthiness of banks and other financial institutions. Much of the equity roller coaster experienced over the last couple of days can squarely be placed at the door of European politicians who's lack of backbone prevents them from allaying growing concerns regarding the soundness of many regional (and even major) European banks – implementation of a ill-conceived short-selling ban has done little than underline the fact that there is a clear problem. Is it a wonder that a possible Bear Sterns is being muted?

Why now?

The question still being asked is why was the pressure released now? Much of the 'bad' news released over the last weeks is not new and has been in the public domain for much of the year. What has changed perhaps is that investors are now focusing on the less probable 'tail-risk' fears which are more headline grabbing than the reassurance one can take from other more positive fundamental data. Living in the aftermath of a US downgrade the realisation that growth will be below trend, and a focus on possible, rather than probable market risk, has created a perfect storm during a usual period of summer doldrums. Having survived such a sizable seismic event, as the one we witnessed these last weeks, we will undoubtedly continue to suffers its ripples and after-shocks for the remainder of the year; heralding a period of slower economic growth.

Without the actual manifestation of a 'tail-risk' we would not expect volatility to be as excessive going forward given corporate earnings expectations will now follow GDP expectations lower and the friction between the two will subside. More importantly we do not believe the current market action marks either the start of another financial collapse (aka 2008) nor the beginning of a 'double dip' recession.

Asset Allocation

During such periods of inflection medium to longer-term portfolios can become temporally disconnected from their underlying benchmarks as assets become priced not based on fundamentals but rather short-term sentiment; are UK Gilts, for example, an attractive investment given a 2.47% yield and inflation running at 4.4% or are you simply "locking in a loss". Even if we see inflation fall over the medium term (as repeatedly forecast by the BoE) once can easily surmise some capital destruction. Do interest rates in the UK, taking their lead from the US, and remain on hold well into 2012 add any more value to holding government debt? Our note "Gilt-y as Charged" expands on this topic and its short term effects on portfolios.

We have, over the last weeks, reduced our equity exposure from a mildly overweight (against a normalised position) to an underweight one in anticipation of continued volatility. Simultaneously we have rotated out of much of our international exposure into more UK focused situations; the UK, for now, is not front-and-centre of investors concerns. Although reticent, for the reasons outlined above, to increase exposure to the UK sovereign debt market we have increased our strategic bond allocation which offers a more nimble and flexible investment approach and added a defensive position in very short term government securities.

We expect these modest allocation changes to keep portfolios positioned for when confidence returns to markets but at the same time will help insulate them for any further falls should they occur.

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