Green Shoots?

June 2009

Following a strong equity performance from mid March to early May, investment observers were wondering whether the 'sell in May and go away' adage would be repeated. In fact, since early May with positive economic news being released about green shoots and talks of economic growth, the FTSE 100 has traded in a narrow range from 4300 to 4500. Which way will it break out?

If it breaks out upwards and then moves through 4700, then this would be a very positive step, but if it falls further then it might be evidence that the bear market (where there are more sellers than buyers of equities) isn't over. There are a number of technical reasons why history tells us we've not seen the end of the bear market.

The first is that recessions last much longer than the 10 months we have experienced so far. All the liquidity and indebtedness problems would imply that this one will be longer than the average of 21 months but shorter than the 1930s experience of 36 months, say 28. While stock markets will anticipate the future, it is unlikely it is doing so 15-18 months ahead of recovery

The policy response from governments has been dramatic and we should avoid the worst of the Great Depression experience but the cost in the explosion of government debt has been astounding. How this will be unwound is the great unknown of the current crisis: there are three options; default, inflation or drastic cuts in public spending. My money is on a combination of the last two.

The recent stock market rally is most likely to reflect the relief that the financial world has not come to an end and that Armageddon has been avoided…. for now. It should also be remembered that during 1929-32 Great Depression there were seven rallies of over 20%.

The recession has not hit the millions of public sector workers or those lucky enough to be in a job or have good pensions / saved wealth. But the increase in unemployment throughout the world, the falling disposable income of the US consumer (who accounts for 70% of US GDP) is clear to see as personal balance sheets are repaired (see my newsletter of June 08 on www.martec.org).

The way the Japanese and German economies, the two main exporting nations, have fallen faster and further than the UK is evidence of a fall off in global demand and there is no indication of an early return to their export trade. This drop in demand has been even more severe than the corresponding period of 1929-32.

We, particularly in the UK as well as the US, have been consuming our future and are going to spend the next 10+ years paying for it.

While all this might present a depressing picture, from an investment point of view, the last two months have shown the importance of keeping some risk in our portfolios. The world is a changing place and it was noticeable that we had a G20, not a G7, meeting in London in April. The group of 20 most important countries included 12 which are designated emerging markets: the days when a cosy fireside chat of the US, Europe and Japan could fix things are long gone. The power now lies in China and India: as investors we have to accept this and adjust our weightings accordingly.

Asia did not embark on the consumer boom, but through their purchase of US treasuries helped to finance the West's insatiable appetite for more goods. It is now their time to spend and the Chinese are already at it: for the last three months ending April, China's consumers purchased more automobiles than the US.

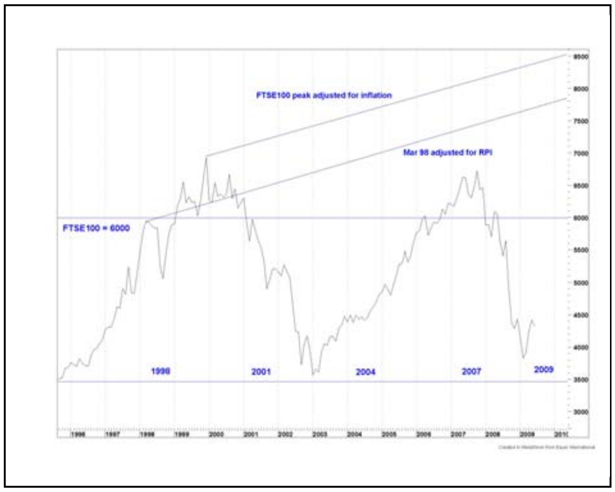
Emerging markets constitute 50% of the world's GDP but constitute only 12% of stock market capitalisation: they take up 75% of the world's land mass and 90% of population. What are the chances that in 10-15 years time, emerging markets will constitute ***less*** than 25% of the world's stock markets? Further in the UK, mining makes up only 0.2% of the economy but 8% of the value of the FTSE 100 index – an anomaly.

There are two main factors which could threaten the recovery of global trade and bring about a 'disaster' scenario; the first is protectionism. The world can survive a bit of tariff building, exchange rate manipulation and domestic favouring at the margins but wide spread protectionism would be devastating.

The second concern would come from government intervention in economies and the capital markets. Malaysia tried this in the 1990s for a time, specifically against the British and it was counterproductive. The signs here are really quite positive: while little reporting has taken place, China and Taiwan, an area of previous tension, signed a number of legal cooperation agreements in late April.

Finally a collapse in commodity prices would jeopardise many emerging economies, especially Africa, but this is likely to be a result of one of the above rather than a cause in its own right.

Investment Strategies



It seems no time but it is, in fact, over 11 years since the FTSE 100 went through 6000 for the first time. The graph above shows the intervening period with two trend lines showing the FTSE revalued to take account of inflation. It shows how low the index is in relative terms and confirms that we are in the middle of a secular bear market which is nearly nine years old.

When we reach the market bottom in this economic cycle it is reasonable to predict that we might then move into the next long term bull market. For the time being, I would prefer to be cautious since I expect to see the FTSE100 re-testing its lows of around 3500, even though the largest companies, such as BP, HSBC, Glaxo etc offer strong defensive characteristics and sustainable dividends.

So what asset classes are preferred? My first asset theme reflects the threat of inflation: if the green shoots of recovery do blossom, then the Bank of England will have to rein in their money printing rapidly which will either drive economic activity back down or be too late and mean more money chasing fewer goods. Conversely if the green shoots wither away, governments will be faced with financing the spiralling debt, resolved through drastic cuts in public services and inflation.

Inflation is the easy option and investors must be extremely vigilant for any signs of it. Prices, officially, are falling at the moment but I anticipate they will be above trend by the end of 2010. I believe the best way to protect a portfolio is through index linked gilts.

My second theme is government debt. There is going to be a significant amount of it over the next few years, but UK gilt yields will have to rise in order to attract investors to buy £140bn of gilts in 2009/10. I therefore favour global government bonds even though they carry the risk of falling in value as sterling appreciates.

There are a few managers who have given outstanding performances over the last 12-18 months and while everyone knows that past performance isn't a guarantee of the future, the combination of a good strategy, a robust investment process and active management is compelling. This provides the third main theme in Martec's current strategy.

There is also the prospect of value in some higher risk plays such as emerging markets gold as well as corporate bonds where there are some excellent yields,.

If the stock market recovery is maintained, this strategy will not deliver as high a return as the balanced sector benchmark. However if markets stagnate or fall, the strategy will provide reasonable wealth preservation and the opportunity to review in 6-9 months when I believe equity markets may be offering some more attractive opportunities.

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