



August 2010 Market Commentary

Quilter

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» Risk appetite returned in July as strong corporate profits more than offset the prospect of slowing economic growth and the sudden political enthusiasm for fiscal austerity.

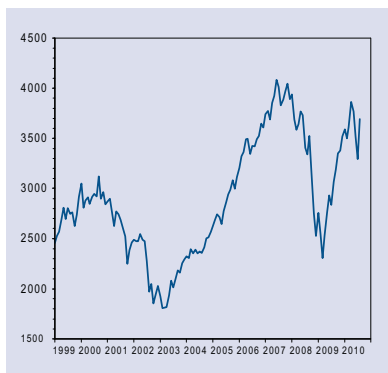
A wide range of leading indicators from freight rates to raw material prices and purchasing manager indices are pointing to a slower growth rate. As a result GDP forecasts for the US, Japan and China have been scaled back leaving Asia and Latin America as the highest growth regions. Forecasts for Europe and the UK are unchanged as they were already very low. Official inflation remains relatively benign and is falling in some regions.

The economic cycle in the US is more advanced than in the rest of the developed world. Consumer spending had held up well - helped by rising equity markets - but the measures aimed at boosting confidence and reflating activity in the aftermath of the financial crisis continue to unwind/expire and the various fiscal concessions scheduled to end over the next six months could lower 2011 GDP by as much as 1%. This, combined with high unemployment and a shrinking private sector workforce, means the stage is set for challenging mid-term elections. The housing market is softening again because the fall in official interest rates has not been passed on fully to borrowers and many

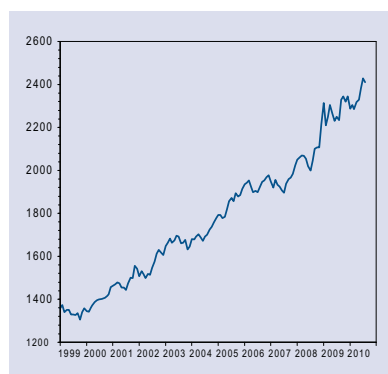
are unable to clear the revised refinancing hurdles. As usual, the corporate sector has been the swing factor in the economic cycle with exports and restocking helping to supplement steady but fairly modest consumer spending. Having exceeded growth expectations in Q1, all contributors now appear to be weakening at the same time and this has prompted downgrades to GDP forecasts and raised fears of a 'double-dip' recession. In our view, it is more likely that the politicians will cave in and roll over the existing tax concessions for another year. The Federal Reserve may even consider further quantitative easing which is one reason why the dollar has fallen in recent weeks.

In contrast, the Eurozone purchasing manager indices have proved relatively resilient although the detailed numbers show that this is almost entirely due to exceptionally strong German exports. The immediate pressures caused by the sovereign debt crisis eased when the results of the ECB stress test on banks were announced in late July. Only seven regional banks technically 'failed' - as against 50% in the tougher US test -

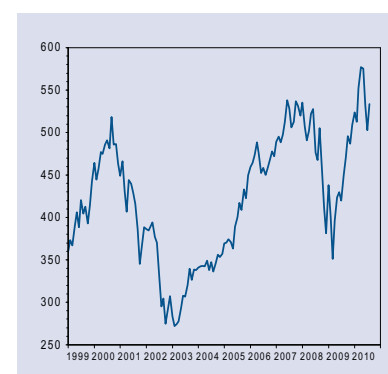
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Source: Datastream

and there was scepticism about the leniency of the assumptions which were based on a mild (3%) GDP downturn over two years and a low (6%) hurdle rate on Tier 1 capital. The tests were carried out on bank trading books rather than on their significantly larger sovereign asset base and, although the decision to publish the results individually provides a welcome increase in transparency, the Eurozone banking system nevertheless remains undercapitalised. As in other parts of the developed world, high debt levels mean balance sheet deleveraging will continue for several years but Europe has the added disadvantage of a fixed exchange rate which means disinflationary sub-trend growth for some time. Despite the difficult economic backdrop, many global companies based in Europe have attractive valuations and are in a good position to take advantage of emerging market growth.

Developing economies are also showing signs of slower growth although this is being seen as a welcome relief in terms of curbing inflationary pressures. The annual GDP rate in China fell to 8% in Q2 with industrial production slowing more than retail sales. The next few months could see a trough in activity as the rate normalises and weaker external demand means a greater reliance on domestic growth. This in turn may enable the authorities to loosen loan constraints and bank reserve requirements. Real estate speculation has been rife with property prices in urban China rising at over 10% per annum but the authorities may decide that the bad debts of insolvent local authorities are an acceptable cost of broader economic stimulus and write them off. The stock market has been weak this year but it is policy uncertainty - rather than a profits downturn - which has been the main influence. This suggests that a pick up

in growth and more stable liquidity could prompt renewed gains for risk assets later this year. Brazil is also slowing quite sharply but India appears to be more resilient with new export orders holding up well.

We are seeing record year-on-year corporate profit increases but attention will increasingly focus on the prospects for 2011 and beyond. Based on an estimated 6% nominal global GDP next year, profitability is forecast to rise around 18% giving a prospective P/E of 11x. While this is not a demanding valuation, companies are already operating on peak margins so the scope for further cost cutting is necessarily limited. This means profits will be increasingly sensitive to sales growth - we estimate every 1% fall in the latter equates to a 6% drop in profitability. On current valuations, the US is more expensive than Europe and the UK although it is worth bearing in mind that there is very little regional variation in the ratings for global companies.

Monetary policy remains distorted but extremely accommodative. With interest rates below inflation and global money supply exceeding nominal GDP, the financial system continues to benefit from abundant liquidity. While some of this is being used to create an environment in which commercial banks are able to restructure their balance sheets, the surplus is being channelled into financial assets thereby inflating prices - particularly of income-generating bonds - creating what may well be the next asset price 'bubble'. Until central bank policy normalises and confidence improves, this 'bubble' could inflate further but for long-term investors equities offer better fundamental value with sustainable dividend yields in excess of government bonds.

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