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News
and views

April 2010

The trend is our friend for now

March saw further gains in global equity markets as investors continued to desert deposit accounts and money market funds in search of better returns. Once again the principal beneficiaries of this trend were equities, commodities and index-linked bonds. This is only to be expected and reflects widespread expectation that in the short term enough has been done to prevent deflation and that in the long term the only way the extraordinary – and still rising – levels of western government debt can be reduced is by a deliberate policy of inflation.

March also marked the anniversary of last year's equity market lows and this has prompted many strategists to rethink their short and medium term outlook. Previous experience suggests that gains of 100% or so in smaller markets and 70% or so in developed markets are not unusual after a crisis. With gains approaching these levels attention is beginning to shift away from stocks that benefit from strong cyclical recovery to those with more defensive characteristics, many of which still offer reasonable value and for those seeking income, secure and rising dividends.

This rotation is driven by two factors. First, almost all recent annual comparisons of economic activity or corporate profits have been against the depths of the credit crunch. Future growth will not be so impressive. Second, recovery brings with it the reversal of the special measures put in place to ensure recovery. This process has already started, for example with the suspension of the Bank of England's £200 billion Quantitative Easing policy and the US acquisition of agency backed mortgage debt. Elsewhere, for example in Australia, rates are already firmly on the rise.

Against this background UK equities rose 6.3% during March, propelled higher by strength in dollar earners, industrials and miners which continued their stellar rise from last year's lows. On the downside, life insurers and utilities disappointed with the Prudential's expected rights issue curbing interest and domestic industries very much out of favour.

Performance - 12 months

Index	Level	Change
FTSE 100	5,680	44.7%
S&P 500 ($)	1,169	46.6%
MSCI Europe ex UK (Eur)	99.7	47.3%
MSCI Emerging Markets ($)	1,010	77.3%
Nikkei 225 (Y)	11,090	36.8%
FTSE Private Investor Balanced	2,860	28.3%
Gold ($)	1,115.00	20.8%
Oil ($)	82.7	38.6%

Source: Bloomberg; Fidessa

The 2009 earnings reporting season that has just ended produced relatively few negative surprises and we continue to find interesting investment opportunities in both large and small companies.

The next three months are likely to be dominated first by the election and then by speculation about future government spending levels. Whatever the outcome sterling and gilts will remain vulnerable. But while the UK's balance sheet is a mess the UK equity market is a different proposition. It long ago ceased to reflect either the UK's economic activities or its fortunes. The mining sector for example now represents over 12% of the stock market, yet there is almost no indigenous mining industry! Our dollar earners and exporters are less sensitive to the UK economy and if we fail to value the better domestic companies appropriately they will simply become bid targets for international buyers.

US equities rose 5.9% as the economic recovery continued to gain traction. Industrial, financial and technology stocks provided the largest sector gains but the more cyclical service sectors, for example media and leisure goods also performed well. Real estate also put in an impressive 9.2% gain as investors returned to the sector.

The story was little different in Europe which saw gains of 7.4% or Japan with gains of 9.5% driven in part by a weaker Yen.

Markets tend to move in cycles and this rally is no exception. Widely credited with leading the way out of the crisis with a stimulus package that dwarfed that of the developed countries China now finds herself under the microscope. The package relied on a massive increase in lending by banks that were already lending at a prodigious rate. Total loans grew 15% in the first quarter of 2009 alone! The fear is that it can only have been achieved by lowering lending standards, the very thing that got the western banks into trouble in the first place.

Observers are right to be concerned. The larger Chinese banks were recapitalised in 1998 and again in 2003 when even the government conceded that 25% of their loans were bad. There has been reform and the government has raised reserve requirements but having led the recovery Chinese equities have been lacklustre so far this year.

Against this background fixed interest had a surprisingly positive month with conventional gilts and index linkers providing positive returns. Linkers continued to rise on the positive outlook for growth and hence inflation while conventional gilts and sterling rallied modestly as fears that Greece's problems would infect the UK and weaker EU members.

Equity markets have risen significantly over the last year in anticipation of economic recovery and as ever will overshoot fair value, perhaps by as much as 15%-20%. For now we will follow the momentum.

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Growth continues to drive asset prices

The US economy continued to pick up after the winter lull with the recovery broadening out across the economy. Retailers, restaurants, hotels and leisure companies are all reporting a pick up while recent employment data showed 123,000 workers found new jobs. This is typical of a normal recovery where both companies and now consumers are feeling more confident about their prospects. US economic growth is forecast to be of the order of 3.5% this year and 2.9% next year with inflation remaining under 2%.

The UK economy typically lags the US by several months and despite the election and cold weather also continues to pick up. The March Manufacturing PMI (Purchasing Managers Index) at 57.2 was an all time high though consumer confidence came off slightly, possibly driven by media focus on the economy ahead of the budget and election.

This benign picture is the same the world over with China's early lead being followed by the US, UK and finally by Europe. The underlying problems remain. We may have dealt with the immediate impact of the credit crunch by flooding the world with liquidity but the debts have not gone away. They have simply been parked in various repositories called bad banks, asset management companies and even central banks. Removing them from sight has allowed the economy to function again, by allowing banks and even governments to issue more debt.

Reducing these debts would condemn economies to years of slow growth or depression. Ultimately there is no alternative but to default on these debts, with inflation the least objectionable route. This continues to drive investors' strategic thinking which favours assets that offer some protection against inflation. These are primarily commodities, equities and index-linked bonds.

Strategy

Collectively our negative view on sterling, the UK economy and gilts continues to drive strategy. In the short term the UK equity market may have become overbought but in the medium term we like the exposure that we can get to economic activity outside the UK and the protection that gives us against a weaker pound. Where we are buyers of bonds we favour international and index linked, rather than conventional gilts, and selected corporate bonds.

Our enthusiasm for international rather than UK assets extends to international equities where growth and the prospect of rising dividends is higher.

Another asset class where we see some value is UK commercial property where both domestic and international interest in good quality assets, particularly in the London area has been high.

Global economic growth and inflation forecasts (%)

2009	2010e	2011e		2009	2010e	2011e
-5.0	1.2	2.0	**UK**	2.2	3.2	2.2
-2.4	3.5	2.9	**USA**	-0.3	1.8	1.8
-5.0	1.1	1.4	**Japan**	-1.4	-0.8	-0.4
-4.0	0.9	1.1	**Euro Zone**	0.3	1.1	0.8
-7.4	3.5	2.8	**Eastern Europe**	7.5	6.1	6.1
			BRICs			
-0.1	5.5	5.0	*Brazil*	4.3	4.9	4.8
-9.0	5.5	2.5	*Russia*	9.2	8.0	8.0
5.7	8.5	9.0	*India*	10.9	8.0	6.0
8.5	10.0	9.0	*China*	-1.4	3.8	5.3
5.4	8.2	7.8	**Asia ex Japan**	2.2	4.6	5.2
-2.1	3.0	3.0	**World**	1.4	2.4	2.6

Source: SG Securities

At a glance

Negative	Neutral	Positive
Sterling Cash	International Bonds	UK Equity
Sterling Bonds	UK Commercial Property	International Equity
	Hedge Funds	Inflation Linked Bonds

Themes

The headline growth theme for the last three decades has been emerging markets where the baton has passed successively from Japan to Korea and Taiwan and on via the Asian Tigers to the BRICs - Brazil, Russia, India and China. With China expanding so rapidly many investment themes are really just sub-sets of that story and all investors need to take care not to unwittingly double or treble the bet. Commodity, energy and Asia plays fall into this macro theme to some extent.

Some of our selections inevitably draw on this theme but have other attractions. For example we like **Amec** not only for its exposure to its exposure to oil, gas and nuclear industries but for its exposure to cleaning up the environment and its involvement in waste management.

Another theme that attracts us is companies with dominant market positions and pricing power, for example internet insurer **Admiral Group** and better established companies like food retailer **Tesco**, household cleaner manufacturer **Reckitt Benckiser** or pharmaceutical giant **Roche**.

Companies that focus on a unique product, service or technology often make good investments provided the barriers to competition remain in place. We would include mobile power generator **Aggreko**, shoe and condom manufacturer **SSL,** platinum refiner and auto catalyst manufacturer **Johnson Matthey** and satellite phone operator **Inmarsat**. We should also include aero engine maker **Rolls Royce** in the list.

An ever popular theme is corporate restructuring which includes a host of situations we can invest in. For example some managers recently backed a placing by investment trust **China Real Estate Opportunities** as part of a plan to move the listing from London's AIM market to Hong Kong. On a similar note others backed **West China Cement** which announced it was moving its listing to Singapore. Both have delivered strong returns.

While many of these themes are international it is wrong to write off companies with large UK operations. **Deutsche Bahn**'s bid for UK bus and rail operator **Arriva** illustrates how even utility style assets can be attractive to the right bidder. We also like undervalued companies.

Still looking for income?

The last year has seen a dramatic decline in yields across the board in almost all asset classes except government fixed interest securities where yields have risen.

Despite this a surprising number of blue chip equities still offer yields that are very attractive relative to deposit accounts and significantly more than the UK market average of 3.0%. These dividends are well covered by earnings and cash and in many cases are still growing. so why are the shares not moving higher as income investors pile in?

The answer is that most investors are still focused on recovery and growth opportunities rather than safety plays. The appetite for risk is high and equity income investing is simply out of favour. Good news for investors who want a high yield now.

With investors chasing growth, recovery and cyclical stocks the large cap income stocks have been left behind

We can still buy Royal Dutch Shell and BP at close to 6%; Vodafone and AstraZeneca above 5% and; Glaxo and BAT at just under 5% for this year. All have well covered dividends.

Companies with a lower yield and strong dividend growth are also worth considering. Remember that if a company grows the dividend by 10% for seven years it doubles. Provided we do not pay silly prices we should see some decent capital growth too. Going for the highest yield available now is not always the best option.

Corporate Bonds

Areas of value remain but new issuance has been small and with many held by long term holders dealing for very large investors can be difficult.

You can still get 8.6% from a corporate bond - but *good value* is hard to find

One bond we have been buying for clients is the 9% Perpetual Subordinated Guaranteed Note issued by Rothschild Finance (C.I.) Limited in 1994. The issue raised £125,000,000 for Rothschild's finance business and the company has the right to buy the stock back at par, £100.00, on 15 February 2024 and again on 15 February 2039.

Standing at £105 the stock yields 8.6% annually with a gross redemption yield of 8.4% to the date of the first call in 2024.

In an ISA or a personal pension that is a very attractive rate of return, though neither capital nor income are protected from future inflation and the performance of perpetual stocks is more volatile.

Taxing times ahead for all

March's budget did little to help income seekers though it did stop short of making the position even worse. For now the generous tax breaks on ISAs and personal pension plans including SIPPs remain. The rate of tax on capital gains is also unchanged at 18%.

FTSE 100 Income Stocks

		MCap	FTSE	Price Earnings Ratio				Yield %				Dividend
Name	Price	£bn	%	H	Y1e	Y2e	Y3e	H	Y1e	Y2e	Y3e	Cover Y1e
Aviva	379.3	10.7	0.7	10.1	7.1	5.9	5.5	6.3	6.9	7.3	7.9	2.1
Scottish & Southern Energy	1,091.0	10.3	0.7	27.9	10.3	10.0	9.4	6.2	6.4	6.8	7.2	1.5
Royal Dutch Shell B	1,851.5	120.0	3.4	13.8	9.8	7.8	7.0	5.9	6.1	6.2	6.4	1.7
National Grid	648.5	16.2	1.1	13.2	11.2	11.1	10.6	5.7	5.9	6.4	6.9	1.5
BP	637.1	120.2	8.1	11.0	9.5	8.1	7.5	5.8	5.8	6.1	6.2	1.8
BT Group	122.3	9.5	0.6	-	8.4	7.8	7.5	2.8	5.6	6.1	6.8	2.1
Vodafone Group	148.5	78.4	5.3	13.5	9.6	9.5	9.2	5.3	5.5	5.7	6.0	1.9
Astrazeneca	2,934.0	42.4	2.9	8.6	7.5	7.4	8.0	4.7	5.3	5.6	5.8	2.5
GlaxoSmithKline	1,273.5	66.2	4.5	11.7	10.6	10.2	9.6	4.8	5.0	5.3	5.8	1.9
British American Tobacco	2,233.0	44.6	3.0	18.1	13.1	12.1	11.1	3.7	5.0	5.4	5.8	1.5

Source: Bloomberg Y1e = Next corporate year end

Fixed Interest

UK 10 year gilt yields remain close to 4%, anchored by the Bank of England's inflation target of 2.5% and expectation that the Bank will restart its Quantitative Easing policy should the market prove reluctant to buy new stock issued by the Treasury.

During the run up to the election we may see yields widen to 4.25% creating a buying opportunity but unless you need to hold gilts we would avoid them even then. 4.25% is not sufficient to compensate for the potential inflation risk nor the weight of new issuance to follow.

So close to an election there was little to be gained financially from the government making changes that would also hand the press and opposition a large stick to beat them with. But with our finances in such a terrible mess the next government will have no choice but to review the situation, whatever their colour.

The ISA allowance this year rises to £10,200 and is available to all over the age of 18 years. We think it prudent to make your annual contribution now and to review the timing of any pension contributions too.

Amec

Attractive

With demand for energy likely to remain high we see Amec as well placed to benefit from its involvement in the oil, gas and nuclear industries while expenditure on environmental clean up and the management of waste provides another growth area.

Amec provides consultancy, engineering and project management services to the world's natural resources, nuclear, clean energy, water and environmental sectors.

The group operates in some 40 countries, and has major operations in the UK and Americas. Leading customers include BG, BP, National Grid, Sellafield Limited, Shell, Southern Company, UK NDA, US states and the US Air Force.

The group is structured into three divisions: Natural resources (51% of revenue), Power & Process (31% of revenue) and Earth & Environmental (18% of revenue). The group has particular specialist expertise in oil sands and nuclear waste disposal while Earth & Environmental, largely based in the Americas is involved in decontamination of US military and other facilities driven by the EPA's Superfund program.

Growth will be driven by a combination of organic growth, small acquisitions and self help. The group is three years into a transformation program that has seen it dispose of low margin businesses and move into higher margin industries.

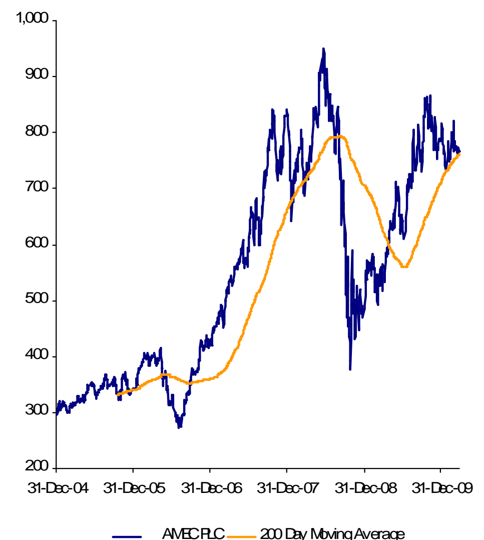
Full year pre tax profits of £204m for 2009 were in line with market expectations though turnover was lower than expected due to project deferrals. With the oil price now firmly back above $80 and the global banking system functioning again we expect investment to pick up again as projects are restarted.

Earnings are forecast to grow by 10% this year and 13% in 2011 putting Amec on a prospective PE of 15.3 falling to 13.4 in 2011.

On a prospective yield of 2.4% the dividend is forecast to grow by 7% this year and 10% in 2011.

At the year end Amec had net cash and short term investments of £742.7m and shareholder funds of £1,026.3. With returns on cash still below 1% all acquisitions are likely to be earnings enhancing immediately.

We view Amec as an interesting play on the energy and environmental themes.



Price (p)		824.5		Ticker	AMEC
Mkt Value (£m)		2,771			
Dec	PBT £m	EPS p	Div p	PER	Yield
2009A	204	47.6	17.7	17.3	2.1%
2010E	237.5	52.4	19.0	15.7	2.3%
2011E	267.4	59.4	20.8	13.9	2.5%

Performance (%)	Absolute	vs FT350
1 month	8.7	**5.7**
3 months	3.7	-0.4
12 months	46.5	1.3

Source: Bloomberg; Fidessa

Recommendations

We rate investment strategies, themes and securities as either positive/attractive or negative/unattractive. This recognises that your attitude to risk, time horizon, financial position, tax position and tolerance for loss versus gain is unique. Your investment manager will only adopt those ideas that in their opinion are suitable for your portfolio and investment strategy at the time.

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