

July 2010

Sell in May and go away?

The general pattern of the last few months continued in June with bonds and gold proving to be safe havens once again. Equity markets weakened further as investors became more cautious about the pace of the economic recovery and as Europe and the UK moved to slash government spending and reduce their fiscal deficits.

We have said for a while that a correction in equity markets is quite normal 12 to 18 months from the market low as investors switch from cyclical recovery to normal growth plays. On this occasion opinion is sharply divided over how fast the global economy will grow from here and the outlook for inflation, both of which are key drivers of equity markets. On the one hand are those who see us entering a deflationary period, exacerbated by government attempts to reduce spending and on the other are those who believe that those attempts in aggregate will have little impact on global GDP but will ensure that interest rates stay low, leading eventually to a surge in inflation.

Unfortunately for investors each argument is not only plausible but requires a completely different asset allocation, with fixed interest favoured if we think we will see deflation and equities, property and other real assets such as gold favoured if we expect to see inflation.

The keenly awaited budget from the new UK coalition government provided few surprises, adding to an already aggressive series of proposed spending cuts announced by the outgoing administration. With the prospect of large scale strikes and sluggish growth it is worth reminding ourselves that the UK stock market is truly international and many companies' operations are entirely outside the UK. Indeed the phrase 'UK equities' is now widely misused.

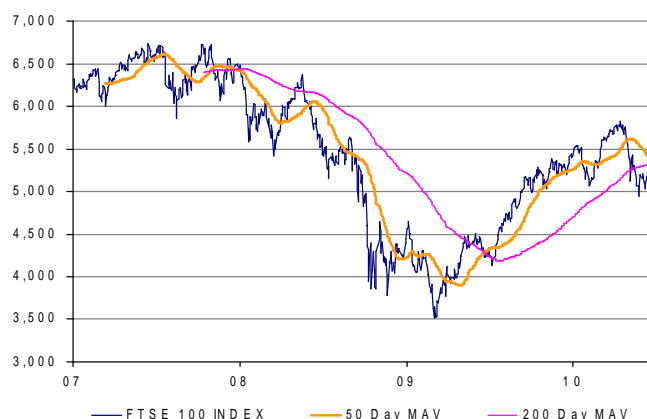
In the UK the FTSE 100 Index lost 5.2% as investors sold cyclical stocks and banks in particular. Once again oil major **BP** was a major loser as the potential costs of the disaster in the Gulf of Mexico continued to escalate. Leading life insurer **Prudential** closed the month 6% lower after investors failed to back its \$35 billion bid for AIA, US insurer **AIG's** Asian inter-

Performance - 12 months

Index	Level	Change
FTSE 100	4,916.9	15.7%
S&P 500 (\$)	1,030.7	12.1%
MSCI Europe ex UK (Eur)	912	16.5%
MSCI Emerging Markets (\$)	918.0	20.6%
Nikkei 225 (Y)	9,382.6	-5.8%
FTSE Private Investor Balanced	1,686.7	16.1%
Gold (\$)	1,240.0	31.8%
Oil (\$)	75.0	-0.3%

Source: Bloomberg; Fidessa

FTSE 100 Index



ests. Both are now vulnerable to a bid.

Amid all this uncertainty we continue to see a steady flow of takeovers that included **BSkyB** up 21.5% on a bid from majority shareholder Rupert Murdoch's News Corp; **Chloride** up 38.5% on a revised \$1.5bn bid from **Emerson** and **Brit insurance** up 20.0% on a bid from US based Apollo.

US equities fared little better as the balance of news turned negative. Poor housing numbers, a sharp downturn in consumer confidence and weakness in the new orders component of the purchasing managers' survey added to concerns over European developments and slower growth in China. The S&P 500 was down 5.4% with continued weakness in consumer cyclicals. Retailers **Sears Holdings**, **J C Penny**, **Best Buy** and **Macy's** fell 20% or more while **Harley Davidson**, always a good barometer of how Americans feel about their personal finances, fell 26.4%. Bright spots included gold miner **Newmont Mining** up 14.7% and Warren Buffet's **Berkshire Hathaway** up 13.3%.

The story was similar in Europe where concerns over the strength of the banking sector, particularly the state owned and Landesbanks, continue to grow. July will see many of these stress tested by the authorities, action that coincided in the US with last year's lows in the sector.

Emerging markets fared better despite rising concerns over the rate of growth and inflationary pressures in China, which also refoated its currency during the month. The MSCI Asia index rose 1.1% but eastern Europe and Latin America put in modest falls to leave emerging markets off 0.9% on the month.

In the short term equity markets are likely to take their lead from the corporate reporting season which begins in the second week of July. With much bad news already priced into shares that may trigger a reversal of fortunes.

London
+44 (0)20 7659 8000

Stockport
+44 (0)1663 761980

Lincoln
+44 (0)1522 721984

Is the bad news in the price yet?

Economics

We have discussed before that we expected a correction as cyclical recovery gave way to normal growth. But what is normal growth? The high level of indebtedness and ageing demographics of the US, UK and Europe all point to lower trend growth in those regions than we have experienced since the war. At the same time it is not evident that despite their impressive growth the developing economies can fill the gap - yet. Add the current enthusiasm for cutting government expenditure in the UK and Europe and it is easy to convince oneself that the global economy will shrink next year.

Global economic growth and inflation forecasts

2009	2010e	2011e	%	2009	2010e	2011e
-5.0	14	2.3	UK	2.2	3.2	19
-2.4	3.7	3.1	USA	-0.3	19	2.0
-5.0	19	18	Japan	-14	-0.9	-0.1
-4.0	11	11	Euro Zone	0.3	15	12
-6.7	3.8	2.9	Eastern Europe	8.9	5.4	6.5
BRICs						
-0.2	6.6	4.6	<i>Brazil</i>	4.9	7.2	7.0
-7.8	5.5	2.5	<i>Russia</i>	118	6.5	8.5
8.0	8.2	8.3	<i>India</i>	10.9	8.4	6.1
8.5	10.0	9.0	<i>China</i>	-14	5.9	5.3
5.9	8.3	7.7	Asia ex Japan	2.1	5.7	5.1
-2.6	3.1	2.9	World	14	2.6	2.6

Source: SG Securities

In fact such a global contraction remains unlikely though a dip back into recession here or there is entirely possible. At present GDP growth of 3% or so seems likely, perhaps 2% if the second half of the year sees an unexpected slowdown. Politicians and central bankers worldwide are firmly committed to growth and it would likely take another crisis to derail it.

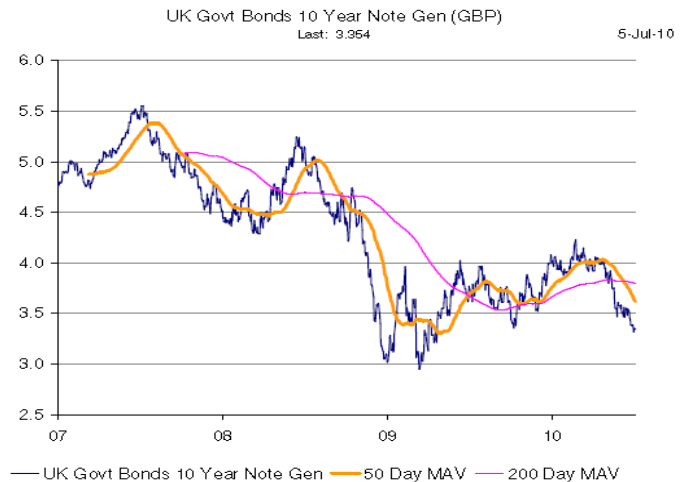
Strategy

The valuation of global equities seems reasonable assuming such modest growth and inflation but investors have been given plenty to worry about this year and are only too aware that the banking sector remains in a very unhealthy state.

The summer months are traditionally a period of low or negative return for stock markets, with September or October frequently marking the low point. We may therefore see further weakness as analysts and investors downgrade their earnings expectations once the half-year earnings season is over. For now equities will remain highly sensitive to changes in investors' expectations of global growth.

PE Ratio		Yield (%)		
2010e	2011e	2010e	2011e	
10.6	8.8	UK	3.7	4.3
13.4	11.4	USA	2.1	2.3
13.8	12	Pacific ex Japan	3.7	4.1
116	9.7	Europe	3.7	4.3
12.3	10.1	Europe ex UK	3.8	4.3
114	9.6	Emerging Markets	2.8	3.2
113	9.2	BRIC	2.7	3.0
13.1	10.9	World	2.7	3.0

Source: SG Securities



Fixed interest fared better and yields continued to fall on 10 year government paper as growth prospects were pared back and as investors sought safe havens.

We find it difficult to believe that a yield of 3.35% on the UK 10 year gilt offers good value to non-tax payers let alone to a private client. On the other hand there are buyers for whom value is measured in different ways. For example the amount of capital that a bank must set aside to back a loan is significantly lower if it is held in 'risk free' government paper rather than in an alternative, say in a AAA rated mortgage-backed security (assuming such a thing still exists!). Potential buyers of gilts at these and lower yields include banks, insurance companies, financial institutions and pension funds.

Those who worry that over-supply must force yields higher would do well to recall that the same was said of Japan in the mid-nineties. In fact it proved no problem at all.

Markets are a discounting mechanism and move to anticipate likely outcomes before they happen. In recent months investors have factored in a wide range of negatives that have included European sovereign debt fears, slower growth in China and a deterioration in US consumer confidence. While these may not be fully priced into markets they are certainly well discounted and provide an opportunity to start moving back towards risk assets.

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

Our investment managers continued to back their favourite themes, many of which are not sensitive to the fortunes of the main market. In particular we continue to back undervalued situations **West China Cement** and **China Real Estate Opportunities** investment trust, now renamed **Treasury China Trust (TCT.SI)** and listed in Singapore.

Following our theme of quality we also added selectively to holdings of **Vodafone**, global manned security giant **G4S**, utility **National Grid** for income and to European utility **E.ON**.

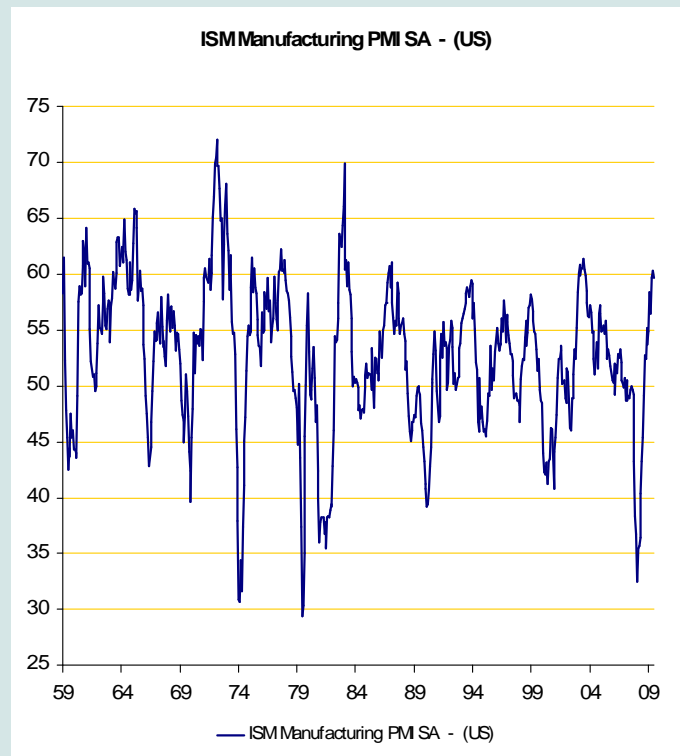
Should we worry about the PMI?

Last month we commented that the current recovery from recession was not particularly unusual and briefly mentioned the Purchasing Managers Index (PMI). This month we thought we would highlight how the PMI has moved over the long term, remembering that a reading above 50 indicates the economy is expanding and below 50 that it is contracting.

As we can see, according to this survey of US businesses the recent recession was similar in depth to those caused by the oil shocks of 1974 and 1979. We can also see that it would not be unusual for the PMI to peak around these levels, indeed it has rarely exceeded 60 or less than 45 for any length of time.

Another consistent feature is the way it spikes. Spikes occur not because the economy is this volatile but because purchasing managers' sentiment and confidence is. They are behaving in exactly the same way as stock market investors do and when they see something that makes them concerned their responses immediately factor it in. Just in case. They also act as a herd, with many respondents taking their lead from what the index is doing rather than taking an entirely independent view.

Given the depth of the fall in economic activity in 2008-9 a rally to at least 60 would be expected. So should we worry if it now falls towards 55? Not necessarily. In fact it would be normal.



Income and savings

Weak equity markets brought modestly higher yields and this month saw a rise in the number of companies yielding more than 4% with dividends more than 1.75 times covered by earnings. **BP** moved to the middle of the pack as it passed its dividend to placate the US authorities. A question mark remains over the level of future payments, with estimates here simply

reflecting analysts' best guesses. Another one to watch is **Aviva** which continues to breach the "Deadly Sevens" (PE below 7 and yield above 7) that has so often provided a warning signal that the dividend is unsustainable. Further down the list is a selection of worthy UK blue chips, many yielding over 1% more than gilts but with rising dividends and international earnings.

Name	Price	M Cap £bn	FTSE %	Price Earnings Ratio				Yield %				Dividend Cover Y1e
				H	Y1e	Y2e	Y3e	H	Y1e	Y2e	Y3e	
AVIVA PLC	315.1	9.0	0.7	4.1	5.8	5.0	4.6	7.6	8.1	8.8	9.9	2.1
ROYAL DUTCH SHELL PLC-B SHS	1576.5	1012	8.3	10.1	8.0	6.4	5.8	7.0	7.0	7.3	7.5	1.8
VODAFONE GROUP PLC	136.5	72.4	5.8	8.3	8.7	8.5	8.5	6.1	6.4	6.8	7.2	1.8
BT GROUP PLC	126.6	9.8	0.8	9.5	7.5	7.0	6.5	5.5	5.8	6.3	7.7	2.3
GLAXOSMITHKLINE PLC	1108.5	57.6	4.6	9.8	9.2	8.9	8.3	5.6	5.6	5.9	6.4	1.9
BAE SYSTEMS PLC	308.5	10.6	0.9	-	7.1	7.0	6.8	5.2	5.4	5.7	5.8	2.6
LEGAL & GENERAL GROUP PLC	75.9	4.5	0.4	5.6	6.5	6.1	5.2	5.1	5.4	5.8	6.3	2.8
TUI TRAVEL PLC	209.1	2.4	0.1	232.3	8.5	7.5	7.0	5.1	5.4	6.1	6.6	2.2
CABLE & WIRELESS WORLDWIDE	85.0	2.2	0.2	-	10.5	8.3	7.6	3.5	5.3	5.8	6.2	1.8
BP PLC	322.0	60.9	4.9	4.6	5.0	4.4	4.0	11.4	5.3	9.4	10.5	3.8
ASTRAZENECA PLC	3,088.5	44.3	3.6	8.3	7.7	7.7	8.2	4.5	5.1	5.3	5.5	2.6
CENTRICA PLC	292.8	15.1	12	23.1	12.2	11.1	10.0	4.4	4.7	5.0	5.4	1.8
MARKS & SPENCER GROUP PLC	333.1	5.3	0.4	10.0	10.7	10.0	9.2	4.5	4.7	4.9	5.3	2.0
ICAP PLC	394.7	2.6	0.2	15.5	11.6	10.2	8.8	4.4	4.6	5.1	5.8	1.9
IMPERIAL TOBACCO GROUP PLC	1850.0	18.8	1.5	12.5	10.4	9.6	8.8	4.1	4.5	5.1	5.6	2.1
INVESTEC PLC	430.6	3.4	0.2	8.5	9.1	7.5	6.0	3.7	4.5	5.5	6.9	2.5
PEARSON PLC	867.0	7.1	0.6	16.3	12.4	11.7	10.9	4.1	4.3	4.6	4.9	1.9
PRUDENTIAL PLC	494.1	12.5	1.0	17.9	12.9	9.4	8.4	4.0	4.2	4.5	4.7	1.8
INTERNATIONAL POWER PLC	295.9	4.5	0.4	4.5	10.5	10.1	9.8	4.2	4.2	4.3	4.5	2.3
REED ELSEVIER PLC	494.8	6.0	0.5	28.8	11.8	10.9	10.0	4.1	4.1	4.5	4.9	2.0
HSBC HOLDINGS PLC	600.1	105.7	8.4	26.7	13.1	9.4	7.6	3.7	4.1	4.7	5.2	1.9
UNILEVER PLC	1742.0	52.9	1.8	16.3	14.1	12.8	11.7	4.5	4.0	4.3	4.5	1.8
REXAM PLC	293.1	2.6	0.2	-	10.2	9.0	8.1	2.7	4.0	4.4	4.9	2.4

Source: Bloomberg

Y1e = Next corporate year end

Ocado

Billing itself as an internet fulfilment company, online grocer Ocado has been in business for 8 years but has never made a profit. So why did the sellers think it was worth £1.2bn and why were professional investors so sceptical?

The problem with valuing any asset is that we have to make assumptions and as the old saying goes: "Assumption makes and Ass out of U and Me". The simple truth is that every time we make an assumption we have to factor in the risk that we are wrong. It is in the vendors interest to down-play risk as this maximises the sale proceeds. It is in our interest to maximise it, to provide a cushion to ensure we make a profit.

Ocado is a high risk investment even on common sense criteria. For example the vendors highlight the 10 year supply agreement with Waitrose as a strength, but food retailing is an intensely competitive business not known for its generosity to suppliers or customers. Why would Waitrose ever allow Ocado to make a decent profit? Surely the best plan is to ensure it makes enough to satisfy Waitrose's needs but nothing more?

In fact rather than invest in the business the Waitrose pension fund actually wants to reduce its stake as do

the other shareholders. Despite the apparently rosy outlook.

Other common sense measures that argue against paying the vendors what they want include:

- More than 20% of the business dependent on one supplier or customer
- A business model that no other grocer has chosen to emulate
- Existing profitable internet competition from supermarkets
- Existing profitable competition from internet retailers in other categories

We will not delve into the technical issues we have with the £1.2bn price tag other than to highlight that private equity buyers would be looking for a far higher rate of return to justify an investment and that the vendors will have considered this before deciding on a stock exchange float.

So is Ocado a bad business? Not necessarily. Its customers love it and that is a big positive. Our problem is that the price tag says more about rate of return the original investors want to achieve on their investment than the future value they want us to share. With plenty of alternatives around it is just not attractive enough.

(New issue - no chart)

Note: The estimates below are from Numis, an underwriter to the issue. For comparison broker Ambrian uses 2015 turnover of £1,092 as a base case and £1,467 as a bull case - suggesting a price of no more than £500m.

Price (p)	n/a	Ticker	n/a		
Mkt Value (£m)	1,180				
Nov	Sales £m	PTP £m	Div p	PER	Yield
2009 A	427	-26.0	-	-	-
2010 E	539.0	-12.0	-	-	-
2011 E	694.0	8.0	-	147.5	-
2012 E	876.0	12.0	-	98.3	-
2013 E	1,150.0	32.0	-	36.9	-
2014 E	1,435.0	72.0	-	16.4	-
2015 E	1,739.0	124.0	-	9.5	-

Source: Numis, Savoy

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.

Regulatory Information

This document/communication is issued by Savoy Investment Management Limited ("Savoy"), which is authorised and regulated in the UK by the Financial Services Authority with Firm Reference Number 145877. Our regulatory details can be viewed on the FSA Register <http://www.fsa.gov.uk/register/home.do> using that reference number. Savoy is a member of the London Stock Exchange.

This document does not constitute or form part of any offer to issue or sell, or any solicitation of any offer to subscribe or purchase any shares or any other interests nor shall it or the fact of its distribution form the basis of, or be relied on in connection with, any contract thereof. This document is not directed at you if we are prohibited by any law of any jurisdiction from making the information in this document available to you. Recipients of this document who intend to apply for shares or interests in any investment are reminded that any such application may be made solely on the basis of the information and opinions contained in the Prospectus or other offering document relating thereto, as and when they become available, which may be different from the information and opinions contained in this document. Securities and derivatives markets may be construed as high risk and may be subject to high levels of volatility. It is possible that Directors and employees of Savoy may from time to time own securities that are mentioned in this communication.

All data and statistics are sourced from Savoy unless otherwise stated. Performance statistics are not necessarily based on audited financial data. Past performance is not necessarily indicative of future results and you may not retrieve your original investment. Changes in rates of exchange may affect the price of units or shares.

For non-professional investors: if you have any doubt as to the suitability of any product, please consult your financial advisor.

Please use the following internet address to view important information about Savoy: <http://www.savoyim.com>

Unattractive