SAVOY
INVESTMENT MANAGEMENT

News
and views

June 2010

European unity tested to breaking point

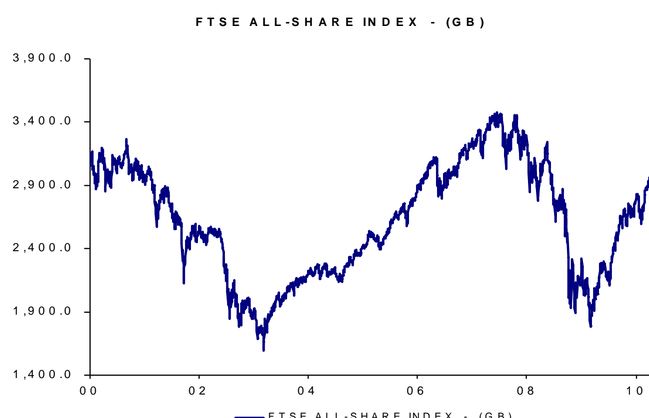
The weakness we saw in April accelerated in May as investors found yet more reasons to worry despite good economic news from the United States. The US dollar, bonds and gold provided positive returns as investors sought safe havens and removed risk from the table. Equities were hit heavily, with the MSCI World Index dropping almost 10% in dollar terms, its worst May since the index began in 1970.

We entered the month with Europe in disarray and struggling to agree a rescue package for Greece. What at first appeared to be a successful resolution to this problem in the form of €725 billion of loans and guarantees proved to be temporary as investor focus settled on the deep-rooted problems in the economic model that is Europe.

Elsewhere in the world investors also found plenty to worry about. The volume of commentary on China increased markedly as investors focused on bad debts within banks, the heavily indebted states and a slowing economy. Observers were also baffled by the sinking of a South Korean warship by North Korea and more recently by Israel's action to stop a convoy of aid reaching Gaza. Against this difficult background global equities lost 9.9% in US dollar terms, the worst May since the MSCI index began in 1970.

Equities fell around the world as investors found yet more reasons to worry despite good economic news from the United States

In the UK the FTSE All Share index lost 6.6%. Oil major **BP** was among the major losers, dropping 24.7% as investors fretted about the potential cost of the disaster in the Gulf of Mexico. Economically sensitive issues such as industrials, retailers and media were also heavily hit together with banks. Bright spots included plumbing, heating and industrial distributor **BSS** which rose 40.8% on the back of a bid from builders merchant **Travis Perkins**; IT company **Kewill** that rose 21.6% on a bid approach and; **Rockhopper Exploration** up over 600% after



finding commercially viable oil reserves north of the Falkland Islands.

Despite positive economic and corporate news US equities fell 8.2% to close down 2.3% on the year. Leading stocks included **Sprint Nextel** up 20.7% on the roll out of 4G phones and a deal with **Walmart**; **SanDisk** up 16.7% as a major supplier of chips for **Apple**'s iPad and; **Dr Pepper Snapple** up 15.7% on strong earnings and a 25% hike in the dividend. Oil services, particularly those involved in US offshore and Alaskan drilling were particularly hard hit by the oil well disaster in the Gulf of Mexico with **Schlumberger** falling 21.4%, **Halliburton** 19%, and **Baker Hughes** 23.4%. The performance of global oil stocks was further hit by weakness in the oil price, which fell over 18.5% during the month.

European equities fared no better with Greece off some 19.2% followed by Ireland off 13.2% and Spain off 10.8%. The banking sector was under pressure once again as inter-bank lending rates rose to reflect heightened fears about balance sheet strength and counterparty risk. The Bank of Spain's rescue of Cajasur simply highlighted a problem common in Europe: regional banks everywhere are overextended and their loans are secured against overvalued property.

The weakness in the western equity markets was mirrored in the east with Japan falling 11.7% and the more speculative 'Mothers' index some 18.1%. China (Shanghai B) fell 16.1% in US dollar terms and the BRIC developing markets index off 9%.

The main beneficiaries of this global reduction in risk appetite were the traditional safe havens of the US dollar which rose against most currencies and US Treasuries where 10 year yields fell to 3.3%. Other beneficiaries included UK gilts where yields fell to 3.6% despite the election outcome, and gold which continues to attract attention as an alternative to paper money and is likely to continue to do so.

Performance - 12 months

Index	Level	Change
FTSE 100	5,188	17.4%
S&P 500 ($)	1,089	18.5%
MSCI Europe ex UK (Eur)	91.1	14.7%
MSCI Emerging Markets ($)	926	19.8%
Nikkei 225 (Y)	9,769	2.6%
FTSE Private Investor Balanced	2,730	15.1%
Gold ($)	1,216.2	24.7%
Oil ($)	74.0	3.4%

Source: Bloomberg; Fidessa

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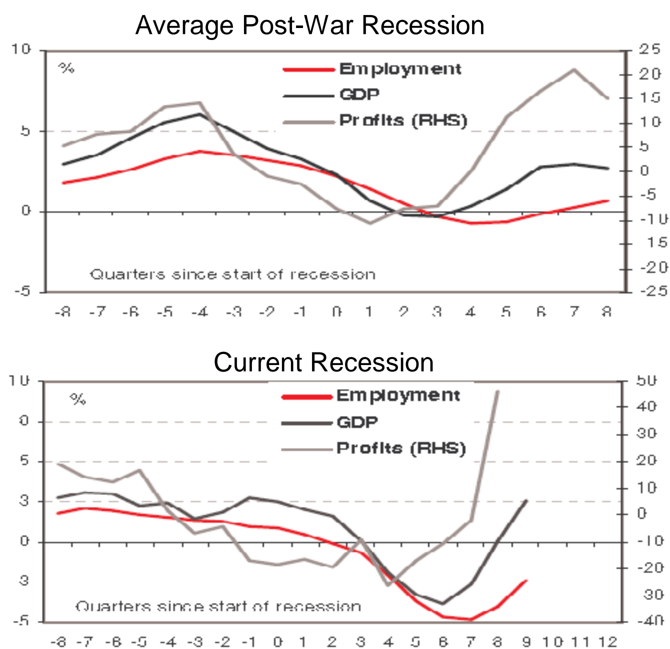
Back to reality

Economic debate was dominated by the crisis in the euro zone but behind the scenes the economic news flow was generally positive. April's US Purchasing Managers Index (PMI) came in at a very strong 60.4 with the new orders and the hiring intentions components both strong. The weakest part was pricing which is not unsurprising given the excess capacity in the system still.

The picture was repeated in the UK with the manufacturing PMI coming in at a high 58 and the services PMI at 55.3, both indicating a strong expansion is in place. Both also indicated high levels of future confidence and that employment intentions were positive. The German manufacturing PMI at 61.5 completes the picture of strong recovery in the US, UK and Europe.

The chart below shows the average growth of employment, GDP and profits during post-war recessions and that the present recovery is not particularly unusual. Both GDP and profits growth are consistent with recovery from a deep V-shaped recession. Employment is typically a lagging indicator and has subsequently turned positive.



Source: SG Securities

This is only part of the picture. The turmoil in the euro zone comes at a very sensitive time for global growth and financial markets. The escalation in risk premium has depressed markets, adding to financing costs and lowering confidence at a critical time. While we do not see a break up of the euro as likely in the short term the tensions within it are substantial and are not about to go away quickly. In the short term the weakness of the euro will help to increase the competitiveness of European exports and provide a boost to Germany in particular which will alleviate tensions.

On the other hand such competitive devaluation is a zero sum game with a weaker euro subtracting from growth in the US, Japan and China. We cannot all devalue our currencies to stimulate growth. Nor can we rely on the heavily indebted US (and UK!) consumer to keep driving the global economy forward. The developing markets need to spend their new found wealth, not simply rotate it back into financial assets via their Sovereign Wealth Funds.

The risk from the euro debacle is that companies respond to heightened uncertainty by delaying investment in plant, machinery and staff, slowing economic growth and potentially pushing us into recession again.

A double dip recession seems almost inevitable

In fact a double dip recession in the developed world seems almost inevitable given the need to curtail government spending.

For example, the current account deficit of over £160bn in the UK will barely be scratched by the government's planned £6.5bn of spending cuts. Considerably more will be needed and one must not forget that these spending cuts are aimed not at shrinking the outstanding debt but simply at slowing down its rate of growth!

Strategy
Markets hate uncertainty and have responded by selling risk assets and buying safety, largely in the form of the US dollar, US Treasuries and gold but also to some extent in UK gilts. This reflects an expectation that interest rates will stay low and that subdued growth reduces the outlook for inflation which is a large component of nominal equity returns.

Global equity market valuation

PE Ratio			Yield (%)	
2010e	**2011e**		**2010e**	**2011e**
10.5	8.8	**UK**	4.0	4.4
13.8	11.7	**USA**	2.1	2.2
13.5	11.7	**Pacific ex Japan**	3.7	4.2
11.6	9.8	**Europe**	3.9	4.3
12.2	10.1	**Europe ex UK**	3.8	4.3
11.4	9.7	**Emerging Markets**	2.8	3.2
11.1	9.1	**BRIC**	2.8	3.0
13.2	11	**World**	2.7	3.0

Source: SG Securities

Lower bond yields also provided support as equity markets traded lower with the FTSE 100 finding good support at 5,000, a prospective yield of 4.0%, some 0.5% higher than the 10 year gilt - a margin of safety that has previously triggered an equity market rally.

Themes
We have continued to use the weakness to pick up selected stocks we like, focussing on companies with strong balance sheets, international earnings and the ability to grow dividends. These have included **Nestle**, **Coca-Cola** and similar defensives but also continental American railway operators **CSX** and **Canadian Pacific Railways**.

In undervalued situations we continued to buy **China Real Estate Opportunities** investment trust and **West China Cement**, expecting to see sharp rises as the companies moved their listings to Asia from London.

We also continue to meet the many smaller companies we have got to know over the years, adding to **Griffin Mining**, a leading miner of zinc, silver, gold and lead in China that sits at a significant discount to fair value.

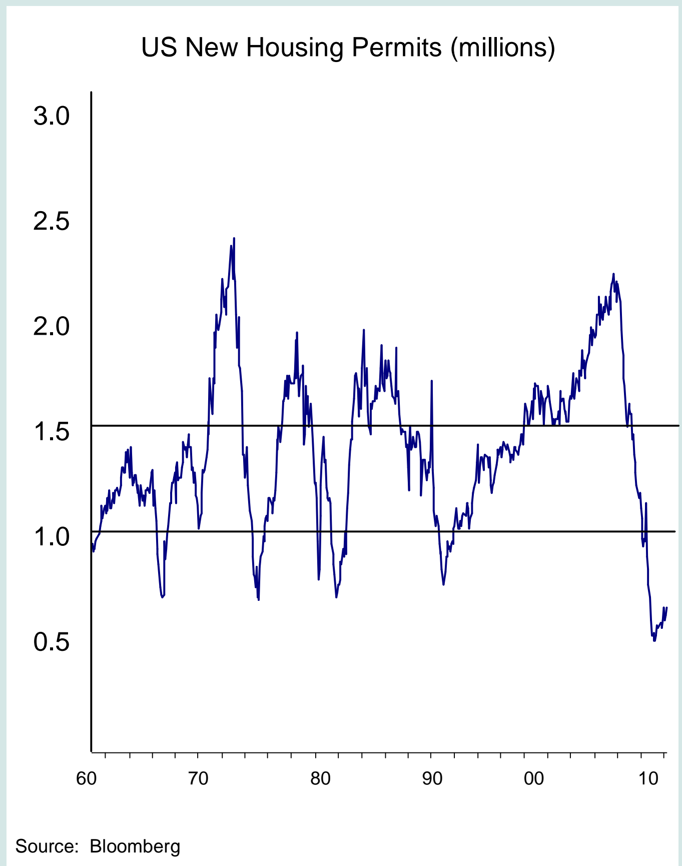
The US housing market

For the last three decades the US consumer, Joe Sixpack, has been a key driver of global growth, consistently spending more than he earned. Joe was helped in his Herculean efforts by a combination of falling interest rates, increasingly easy lending criteria and by politicians keen to see the economy blossom. Who can forget Bill Clinton's 1992 election slogan "It's the economy, stupid"? Even central bankers lent a hand, with Fed Chairman Alan Greenspan shifting his view from worrying about 'irrational exuberance' in December 1996 to becoming a full convert to the 'new paradigm' only a few years later.

Every time something went wrong he simply lowered interest rates, ensuring that the party continued through the night and into the small hours. The chart on the right shows how many US housing permits were issued annually since 1960, typically 1 - 1.5 million. It also shows how every few years as the economy overheated and interest rates rose private house building shuddered to a halt while excess inventory was cleared. House building roughly kept pace with population growth, which rose from 179 million to today's 309 million, a gain of 130 million or 72%.

The penultimate fall was known as the Savings and Loans crisis. The US government was forced to bail out 747 so-called 'thrifts' that had extended too much credit in the form of mortgages, personal loans and auto finance. It cost $160bn of taxpayers' money to fix. But no lessons were learned.

The credit crisis has its roots in US housing. Sales and prices are only now beginning to pick up, helped by tax credits but as the chart shows the present rate is still about 50% of the long run average. For the patient that must be an opportunity. After all, the population continues to grow.



Source: Bloomberg

Income and savings

During May the Organisation for Economic Cooperation and Development (OECD) announced that the UK should raise interest rates to 3.5% by the end of 2011 to ward off inflation. That seems unlikely and a number of FTSE 100 stocks currently yield more than 4.0% with their dividends more than 1.75 times covered by earnings. As usual we urge caution about those at the top of the list, particularly those breaching the 'Deadly Sevens' - those with a yield over 7% and a PE (Y1e) under 7. It often means that analysts' earnings forecasts are simply too high. And of course, dividends can be cut.

		Mcap	FTSE	PE Ratio				Yield %				Dividend
Name	Price	£bn	%	H	Y1e	Y2e	Y3e	H	Y1e	Y2e	Y3e	Cover Y1e
BP PLC	433.4	81.4	6.2	5.8	6.0	5.2	4.8	8.9	**8.8**	9.3	9.8	1.9
AVIVA PLC	329.1	9.2	0.7	4.3	5.8	5.1	4.6	7.3	**8.0**	8.7	9.5	2.2
ROYAL DUTCH SHELL PLC-B SHS	1,740.0	111.0	3.6	10.6	8.3	6.7	6.0	6.7	**6.7**	6.9	7.1	1.8
VODAFONE GROUP PLC	138.7	73.0	5.5	8.4	8.8	8.5	8.4	6.0	**6.3**	6.8	7.2	1.8
BT GROUP PLC	130.1	10.1	0.8	9.8	7.7	7.2	6.7	5.3	**5.8**	6.2	7.7	2.3
THOMAS COOK GROUP PLC	200.2	1.7	0.1	160.1	7.4	7.0	6.5	5.4	**5.6**	6.0	6.5	2.4
ASTRAZENECA PLC	2,950.0	42.5	3.3	7.6	7.0	7.0	7.5	4.9	**5.6**	5.8	6.1	2.6
LEGAL & GENERAL GROUP PLC	77.8	4.6	0.3	5.7	7.0	6.3	5.3	4.9	**5.3**	5.7	6.2	2.7
BAE SYSTEMS PLC	321.0	11.1	0.9	-	7.4	7.3	7.0	5.0	**5.3**	5.5	5.8	2.6
GLAXOSMITHKLINE PLC	1,175.0	61.0	4.7	10.4	9.8	9.5	8.9	5.3	**5.3**	5.6	6.0	1.9
TUI TRAVEL PLC	228.0	2.5	0.1	253.3	9.3	8.1	7.5	4.7	**5.0**	5.6	6.1	2.2
ICAP PLC	394.0	2.6	0.2	15.5	11.7	10.4	8.8	4.5	**4.6**	5.1	5.7	1.8
MARKS & SPENCER GROUP PLC	339.9	5.4	0.4	10.2	10.9	10.1	9.4	4.4	**4.5**	4.8	5.1	2.1
IMPERIAL TOBACCO GROUP PLC	1,917.0	19.5	1.5	12.9	10.7	9.9	9.1	4.0	**4.4**	4.9	5.4	2.1
REED ELSEVIER PLC	476.7	5.8	0.4	27.7	11.4	10.5	9.7	4.3	**4.3**	4.7	5.0	2.0
INTERNATIONAL POWER PLC	293.9	4.5	0.3	4.5	10.5	9.9	9.2	4.3	**4.3**	4.3	4.6	2.2
LONDON STOCK EXCHANGE GROUP	621.0	1.7	0.1	18.4	9.7	8.8	7.7	3.9	**4.2**	4.4	4.6	2.5
HSBC HOLDINGS PLC	630.1	110.3	8.3	26.6	13.0	9.2	7.4	3.7	**4.1**	4.7	5.3	1.9
PEARSON PLC	939.5	7.6	0.6	17.7	13.4	12.7	11.9	3.8	**4.0**	4.3	4.5	1.9
INVESTEC PLC	481.3	3.6	0.2	9.5	10.2	8.4	6.8	3.3	**4.0**	4.9	6.1	2.5

Y1e = Next corporate year end

Griffin Mining*

Attractive

Over the years Savoy has built up considerable expertise in a number of specialist areas of the market including small companies. Investing in small companies can be very rewarding but as most are too small to have diversified businesses they tend to be more exposed to a smaller range of factors and viewed as higher risk.

To spread the risk many investors use funds, while some fund managers avoid them altogether, sometimes simply because the cost of due diligence would not be recouped in commission or fees earned! Others worry that when the market falls they will be unable to sell. Typically this means most are under-researched, under-owned and as a result under-valued.

We met a wide range of companies last month including small company Griffin Mining who we have known for a long time and has an interesting story to tell.

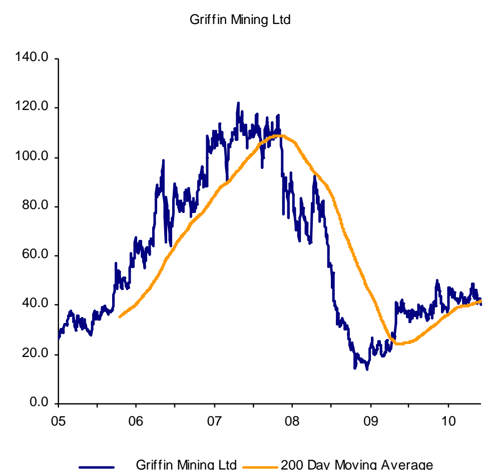
Griffin was formed in May 1988 in Bermuda as a mining finance company and listed on London's AIM market in June 1997 as a mining company. In March 2008 it completed the acquisition of China Zinc Pty Ltd, giving it 60% ownership of a Chinese joint venture company with rights over extensive zinc and gold reserves at Caijiaying in the Hebei Province in Northern China some 200 km north west of Beijing. To give an idea of scale the reserve life is usually referred to as 100 years though licences to mine at different depths are granted over shorter periods. The group also has a 39.2% interest in Spitfire Oil.

Griffin is a low cost producer, benefiting from proximity to market and a largely Chinese cost base which gives it a significant advantage.

As a foreign majority owner of a large mineral resource politics is a concern , however the local JV partners are government bodies with an interest in developing the mine further and are also potential acquirers of Griffin's interest which is significantly undervalued. China is rapidly extending her sphere of influence internationally to increase access to minerals.

Legacy technical problems, now overcome, halted production early in 2009 and the company made a profit before tax and minorities of £4.5m, processing a total of 320,883 tonnes of ore compared with 433,274 in 2008. With production now back on stream profits are set to rise sharply.

The shares stand at a significant discount to fair value, raising the prospect of corporate activity or a transfer of the listing to Asia where they would receive a higher valuation.



Source: Bloomberg; Savoy

* All AIM stocks are considered higher risk investments. You should ask for clarification of the risks before investing.

Price (p)		40.25		**Ticker**	GFM
Mkt Value (£m)		73			
Dec	PTP m	EPS	Div	PER	Yield
2009A	4.5	1.2	0.0	33.0	0.0%
2010E	17.0	4.1	0.6	9.8	1.4%
2011E	24.8	6.0	1.4	6.7	3.5%

Performance (%)	**Absolute**
1 month	-7.5
3 months	-9
12 months	-1.2

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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