

outlook

October 2011



World

Awaiting the euro rescue 'D' Day

Markets had a torrid time in the third quarter and exhibited enormous volatility. The reason for this was that they had to contend with two powerful and simultaneous headwinds. The first was a rapid decline in economic momentum in both the US and Europe. Confirmation of this came with the recent reduction in growth estimates for advanced economies by the IMF. They reduced their 2011 estimates from 2.2% to 1.6% and their 2012 estimates from 2.6% to 1.9%. The rapid decline in US, UK and German bond yields to 60 year lows is also a powerful indicator that developed economies are recalibrating to a much lower nominal GDP growth trajectory (the New Normal).

The second major headwind, that has increasingly preoccupied the markets, has been the significant escalation in the Euro-zone debt crisis. The shift in focus to Italian solvency, combined with an inadequate political and leadership response to the crisis has raised legitimate concerns over the survivability of the euro itself. The systemic risks posed by the potential unravelling of the euro are global in nature and have contributed to the risk off positioning of markets and increased tension in the interbank market. The recent direct involvement of US Treasury Secretary Geithner in trying to establish a sizeable bail-out plan is testament to the gravity of the situation. The timetable for delivery of this plan is extremely tight with

the G20 meeting in Cannes on November 4th the supposed 'D' Day. Failure to deliver a cogent package would be extremely serious.

In the UK the MPC appear willing to accept responsibility for rekindling dwindling demand by restarting a programme of QE. While a decline in nominal GDP growth infers pressure on corporate revenues and consequently negative operating leverage, a 4.5% prospective dividend yield lends support to equities. We think we are gradually moving to a Nifty Fifty world whereby a select group of companies that have business models that can deliver growth in a New Normal world move to significant valuation premiums. This implies active stock picking is going to become increasingly important to alpha generation.

US

Operation Twist – damp squibb

Any hope that the USA economy could deliver a resumption of growth once the supply chain disruptions (a consequence of the Japan earthquake) unwound, evaporated in Q3 2011. As with the UK and Europe the combination of stubbornly high unemployment, the euro zone debt crisis, stress in the interbank market and dysfunctional leadership on both sides of the Atlantic has created enormous amounts of uncertainty and economic inertia. The Federal Reserve acknowledged this at their latest FOMC meeting by emphasizing that 'there are significant downside risks to the

economic outlook'. The implementation of 'Operation Twist' (the switching of short dated to longer dated bonds held by the Federal Reserve) left the markets underwhelmed because it will only have a muted impact in reducing mortgage rates and therefore stimulating the economy. More alarmingly, it emphasized that after 2 big doses of QE the Fed has for the time being limited ammunition left in its armoury. The divisions within the FOMC and the intense criticism of QE by the 'Tea' party republicans have made it extremely difficult for the Fed to remain proactive and provide the 'put' that markets have become accustomed to. Despite losing its AAA rating post the debt ceiling negotiations the US bond market has registered strong gains with yields approaching record lows. This partly reflects the flight to safety trade as investors fret over the systemic risks facing Europe but also a growing realization that the US economy is tracing out an extremely low nominal GDP growth trajectory.

UK

MPC confronting 'policy defeatism'

The UK economy is suffering. The latest MPC minutes noted the 'deterioration in conditions in the domestic economy' and that 'the balance of risk of inflation has shifted to the downside'. This analysis was reinforced by the news that both the IMF and the OECD have ratcheted down their second half growth expectations for the UK to 0.1% which would leave annual growth for 2011 close to 1%. They also

reduced their 2012 growth estimates from 2.3% to 1.6%. While these downgrades were part of an overall downsizing of growth expectations for the advanced economies it has raised questions over the requirement to inject stimulus into the economy.

Although the MPC voted to keep monetary policy unchanged in September a significant part of their meeting was spent considering a range of potential policy responses. This ranged from reducing the bank rate to 0%, to giving explicit guidance of future interest rates, to changing the maturity of their portfolio of assets and finally expanding quantitative easing (QE). There is little doubt that another tranche of QE will commence soon. It might well coincide with the Autumn Review undertaken by the OBR in late November which will surely show a deterioration in the government's fiscal targets. More importantly the agenda is already shifting to the consideration of using QE in a more holistic manner. For instance, Adam Posen on the MPC has warned about the need to counter 'policy defeatism' and to use QE to provide credit to small and medium enterprises directly, circumventing the banking sector.

Europe

Approaching the moment of truth

Markets have continued to exert enormous pressure on EU policy makers to confront the peripheral debt crisis. Signs that the interbank market was starting to seize up,

much as it did prior to the Lehman crisis, in response to the uncertainty over the capital structure of banks have globalised the concern. The systemic risks posed by either default or the unravelling of the euro are significant.

The core problem is that the Germans remain unwilling to commit unequivocally to the establishment of a fiscal union. They are understandably reticent about locking themselves into long term fiscal transfers. The lack of decisive leadership combined with evidence that the EU economy is rapidly losing momentum is exacerbating the solvency squeeze and encompasses Italy which is seen as too big to save.

The crisis dominated the recent IMF meeting in Washington DC where under the scrutiny of global leaders the Europeans finally accepted the notion that Greek default is inevitable. Consequently, planning has already started on how to recapitalize banks, significantly boost the EFSF and ring fence Greece to limit contagion risk. The G20 meeting in early November is where many of these details will be outlined. While enormous implementation risks remain, and markets have learnt to be sceptical over EU politicians' ability to deliver to tight deadlines there is something cathartic about the ending the period of denial over Greek solvency. Europe and the euro are approaching their moment of truth. Failure to deliver will be extremely damaging.

Asia

China

While Chinese growth will undoubtedly be impacted by the combination of the weakness in developed economies and the delayed impact of tighter domestic policy, the economy still looks capable of delivering somewhere between 8.5-9% growth this year and next. By Chinese standards this constitutes a soft landing. The government is endeavoring to reorientate the economy away from export to consumption led growth. If the economy was to show signs of decelerating too fast then fiscal stimulus will be deployed – unlike 2009 it will focus on tax cuts (boosting demand) rather than infrastructure projects.

While CPI inflation is proving stickier than expected and remains above 6% the decline in M2 money supply growth and the recent fall in commodity prices indicate that inflation should start declining soon.

Japan

The Japanese economy has started to recover from the impact of the earthquake and tsunami. The supply chain disruptions were not as great as first feared and consensus forecasts expect the rebuilding process to deliver 2.8% growth in 2012. The yen has rallied significantly partly in response to capital repatriation but also due to its safe haven status. The pressure this is exerting on the economy and corporate margins has prompted the finance minister together with the BOJ to consider measures to curtail the recent strength of the currency.



Smith & Williamson Investment Management, a trading name of NCL Investments Limited (Member of the London Stock Exchange) and Smith & Williamson Investment Management Limited. Both companies are authorised and regulated by the Financial Services Authority.

Disclaimer: This document contains information from sources believed to be reliable but no guarantee, warranty or representation, express or implied, is given as to its accuracy or completeness. This is neither an offer nor a solicitation to buy or sell any investment referred to in this document. Smith & Williamson Investment Management documents may contain future statements which are based on our current opinions, expectations and projections. Smith & Williamson Investment Management does not undertake any obligation to update or revise any future statements. Actual results could differ materially from those anticipated. Appropriate advice should be taken before entering into any transactions. No responsibility can be accepted for any loss arising from action taken or refrained from based on this publication. Smith & Williamson Investment Management is a trading name of NCL Investments Limited and Smith & Williamson Investment Management Limited. Authorised and regulated by the Financial Services Authority.

Offices: London: 020 7131 4000, Belfast (Cunningham Coates Stockbrokers): 028 9072 3000, Birmingham: 0121 710 5200, Bristol: 0117 376 2000, Glasgow: 0141 222 1100 and Guildford: 01483 407100