

View from PIM

“Hard Knock Life”

Tom Becket, Chief Investment Officer

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The general public rarely reserves any sympathy for people who work in financial markets. After the chaos wreaked upon the global economy by “bankers” in 2008 this should probably come as no surprise. However after the catalogue of crises inflicted upon the financial system this year, some sympathy might be due. This has certainly been a year to remember in markets and one we will all be pleased to see the back of. As we gaze nervously in to the distance, we are worried that 2012 might not be much better, until we are allowed some clarity and closure on the European soap-opera that leaves us on a “cliff-hanger” ending after each daily episode.

Given the number of shocks that have hit the financial system and global economy this year, it is reassuring that financial markets have now recovered the lion’s share of the losses suffered during the miserable summer months. Many have suggested that the equity markets’ ability to ride a wave of such huge proportions is unrealistic. **We would agree that the pace of the gains enjoyed during October was unlikely to be maintained as we moved in to November. We had once again de-risked our investment strategies, having enjoyed one of the best months for asset returns for many decades.** In recent days we have debated whether we would reduce risk even further, mindful of the lack of resolution to many of the issues that plague the global economy. However, as we outlined in last month’s newsletter, we can find great comfort that there is so much inherent value to be exploited in financial markets at this time, as long as investors are willing to be patient and ride the volatility that markets will continue to serve up in the coming months.

Of the unresolved issues, certainly Europe has grabbed the attention of both investors and the media alike. The truth is that every positive comment from Europe normally ensures a good day for markets, while the next troubling development ensures the opposite. The simple fact is that in October we had more of the former than the latter, equating to a strong month for markets. In November we have had a more mixed picture, which explains the day to day volatility. **Certainly on our analysis we believe that the latest solution for the Eurozone’s woes announced 10 days ago is materially inadequate and certain to be exposed to a great deal of further scrutiny in the months ahead. Their solution is not sufficient on any of the core issues of banks’ capital, forgiveness of Greek debt or the wider peripheral European solvency issues.** It was in fact another message of hot air and bluster, lacking almost entirely in detail. Sadly, we were not surprised. Certainly the most important current barometer of

- Markets recovered their poise in October
- Confidence has improved but remains brittle
- Many short term problems are unresolved
- The structural issues are yet to be addressed
- 2011 might be a sign of days to come

European political success is the Italian bond yield, which by constantly rising is indicative of a vote of “no confidence” in the latest solution and the political leaders of Europe. **To us, the Greece issue is a secondary issue in this farce; Italy, Spain and France are the big beasts that need taming.** Worryingly all three find themselves in an undeniably poor fiscal state, which is becoming all the more obvious as Europe falls into another recession and the spotlight shines on their stretched balance sheets.

Those stricken nations will all argue that they are in fact in no worse a condition than their cousins across the developed world, (of course with some exceptions such as Germany), but investors have been unnerved by the European leaders’ flimsy grasp on the serious situation in their backyard and the shortcomings of the remedial measures proposed to date. Of course the European leaders could also point to the inability of US politicians and G20 to achieve any harmonious decision making, but for now that is not the point. It is time for Europe to get “their house in order”. They have to find a way to shore up confidence in their financial system. At the same time they must sort out the solvency issues in the Southern European states and accept that greater fiscal unification is the only way to draw a line under this crisis. **Europe remains the greatest danger by far to the global economy and, by implication, our client’s portfolios. Until we see the decisive resolution that we have craved for well over a year now, we will be reluctant to reverse our recent steps to reduce risk.**

Whilst the gaze of most has been transfixed upon the farcical rumblings in the “Club Med” countries, there has been a host of other important developments across the world. Some have even been positive! **In particular there has been evidence from the US and China that our view that the global economy was suffering from a “soft patch” in economic growth, rather than another recession, was correct.**

Recent economic data released from the world's two biggest economies have been demonstrative of a global economy that is solid, if unspectacular, suggesting a long and low grind for the global economic engine. **As yet, the recession in Europe remains rooted solely on that continent, although it seems increasingly likely that the UK will follow the same path. If the UK doesn't fall in to recession, we seem certain to suffer from such low growth that it will impact upon our ability to pay back our excessive debt burden, in much as the same way as for our European cousins.** Fortunately as global investors we have the ability to focus our portfolios on areas of growth in the world.

Corporate results from across the world have again been robust. **The strongest company reports have again come from the US, which is a positive support for our conviction in US High Yield Corporate Bonds, as there have been further signs of companies paying down debt and strengthening their balance sheets.** Certainly there have been some areas of disappointment for global companies, but they were predominantly in cases where reduced European demand had impacted profits, or where expectations for sales in the Emerging Market economies had been too high. Generally there have been no concrete signs from company managements that their outlook for revenues and profits has deteriorated due to the unsettling events in Europe. On the flip side, there remains a general reticence amongst managements to predict anything other than an uncertain future. **On reflection, there has been nothing that can deflect us from our "neutral" stance to equities and our primary focus on high quality companies who are able to continue to grow in a "low growth" environment.**

Central bankers from around the world have tried their best to reignite enthusiasm in markets. The Europeans decided last week to start to reverse their insane decisions to raise interest rates earlier this year. This follows rate cuts in Brazil, Indonesia and Australia, where the authorities have deemed that the global economy and end demand for their products is sufficiently impaired to justify cutting interest rates. **In the UK we have opted for more Quantitative Easing. Given that this strategy achieved so little last time we attempted it, we are not hopeful of a boost for our labouring economy, but we are hopeful that it will weaken sterling to the benefit of our overseas investments.** We are concerned about the impact that it will have upon inflation, so have decided to maintain our positions in index-linked bonds, despite their rich valuations. In Japan the

central bank has plumped for currency devaluation as their weapon of choice. The US Federal Reserve seems to believe that hyperactivity is the cure to solve their various structural economic woes. Broadly, global central bankers have sought to demonstrate over the last few weeks that they are on the side of investors and will try to boost confidence in markets and re-fuel the global economy next year.

Of course there are risks that 2012 might follow in the same vein as this annus horribilis, although frankly it is hard to imagine that the volatility of the last few months can persist. There have been many days when the prices of global banks and the world's largest mining companies have gone up or down by close to 10%, with very little change to their actual fundamentals and outlook for profits. In fact, such extraordinary moves have become ordinary and hardly raise a mention on day to day basis. **Because of extreme fluctuations in investor sentiment and individual asset prices, it has become extremely hard to control short term portfolio volatility. Our current aims are to try and exploit the best opportunities we see in financial markets, but at the same time to try to focus on quality assets, which we hope should be less volatile.** Recent history has taught us that quality assets should fluctuate less over the medium term, although over the short term it can be anyone's guess how any asset might perform in today's financial markets. A graphic example of this was in the last two weeks in September, when quality assets were actually punished for having previously performed well.

Of course not even the prescient Nostradamus could have predicted the various financial crises, the incessant political failures, the revolutions, the earthquakes or tragic tidal waves that have hit markets in 2011. Surely we are due a period of calm in financial markets and healthy, lowly volatile returns in our portfolios? That might sadly be wishful thinking given the challenges that exist for investors in this "hard knock" world, but we remain confident of achieving decent returns in the coming years. **Sadly this will be dependent on political factors that are out of our control, so for now we remain well diversified in our portfolios, with a balance of different asset classes and higher levels of liquidity, just in case we are let down again by the politicians.**

Thomas Becket
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