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— FROM DELMORE ASSET MANAGEMENT —

Global Commentary **18th May 2010**

The OECD workout begins

Introduction

The sovereign debt crisis continues to affect world markets. Those countries which fail to accept the demands of the bond vigilantes will see extreme pain before their ultimate submission. Mr Trichet's remark that the crisis could be the most serious since the First World War underlines the nervousness of many officials. At the moment markets have become more cautious as we battle through the sovereign debt crisis. We believe the dithering by EU governments has prolonged the crisis and ensured continued volatility for much of this year. Before the Greek stand-off, markets were beginning to believe that we were through the worst; now they are confused.

The business survey results for the next few months will provide hard evidence of how badly confidence has been dented by the Greek tragedy. The rush into gilts and US treasuries, with the attendant falling yields, needs to be reversed soon otherwise equity markets could fall further. Alternatively confidence could gradually return and the crisis subsides; with bonds falling and equities rising on further clear evidence of a broadly based global recovery.

Our central view is that the recovery is beginning to take hold and that prospects in the emerging markets, particularly Brazil, Russia, India and China, are providing a considerable stimulus to world growth. Consumers plus small and medium-sized businesses within OECD economies are still stretched, but the large quoted corporations have managed to rebuild their balance sheets substantially; using equity and loan stock issues over the last 12 months. Globally the level of money raised in the first quarter of 2010 was once again substantial; it is clear that large corporations are sitting on a lot of cash.

US unemployment is high but so is productivity

The recession has taken on different shapes around the world. In the United States there was a savage reaction to the downturn, causing a sharp rise in unemployment to almost 11% and a rapid depletion in stocks. As stocks were rebuilt in the second half of 2009, most businesses attempted to produce more with the same labour force on slightly longer hours. Where extra people were recruited this was usually on a part-time basis. This is the classic shape of a recovery from a recession, particularly one as severe as the recent one.

As a result, productivity in the US has risen to historically high levels, up more than 9% in the year to 31 December 2009. Naturally, profits do very well when costs are tightly controlled and sales recover some momentum. Earning reports for the first quarter of 2010 have once again shown the resilience of the US economy, with expectations of a near 50% rebound (adjusted) from the trough earnings of March 2009.

UK and Europe "hoard" labour

In the UK and Europe, particularly Germany, there have been some attempts to hoard labour. This has been encouraged by national governments and has been partially successful. As a result, unemployment in the UK has not risen nearly as much as the severe drop in output might have suggested. During this recession, output in the UK private sector has fallen by 8% whilst total national GDP has fallen by 6%. The difference is down to considerable government efforts to pump money into the economy, partly by delaying tax demands and particularly by increasing government employment.

UK Inflation

We have also seen a substantial rise in inflation in the UK given the scale of the recession. This is due partly to the effect the depreciation of sterling has had on input prices. The reinstatement of the old VAT rate of 17.5%, an effective increase in prices of over 2%, has also impacted the inflation numbers. Finally, the sale of new and used cars makes up a significant proportion of the basket for the CPI Index. The price of new cars has been quite strong and the supply of second hand cars has been much restricted over the last year. As a consequence, the price of used cars has risen by 15%. This has also made a discernible contribution to the UK's high inflation which in April reached 3.7%. The high inflation rate remain a concern for us, as we have doubts about Mervyn King's capacity theory. We would be surprised if the CPI drops below 3% by the end of the summer period.

Whilst the mathematics make some sense, it seems UK businesses have been more successful in passing on their increased costs to customers both in the UK and abroad. This keenness to raise prices and to try to restore margins has dampened demand for UK goods and services in spite of the substantial depreciation of the pound. The fact that labour has been hoarded also affected wage levels and helped to support demand and higher prices.

UK: Into the Mincer

There will be substantial changes in the UK. Virtually all economists agree the government needs to produce a viable plan for contracting public spending over the next five years. The crisis has saddled the county with enormous national debt, which needs to be pared down over time in order to allow the private sector room to grow. Bank credit is still scarce for SME's and consumers, whilst the considerable credit advanced by the tax authorities is being wound down.

Some eminent economists, including Professor Blanchflower, who was recently sacked as a member of the MPC for his forthright views, believe attempts to cut government spending this year risk tipping the UK economy back into a recession. Others believe cuts should be as immediate as possible, indeed the new government is set to announce the first £6bn next week. Now that the bond markets are on heightened alert for decisive action, the argument has become academic!

Do not confuse London with Athens

There have been wild rumours in the financial markets that the UK is on the cusp of a meltdown similar to that suffered in Greece. This is an alarmist scenario not based on solid facts. Our national debt has an average term of about nine years compared with circa three years in Greece. Obviously funding such a short term debt maturity presents substantial problems.

Whilst we recognise the existence of the black economy in the UK, it has not become as much a part of the national persona as in Greece, where people announce with pride that they do not pay tax. The national trait hit the headlines this week with the resignation of the Greek deputy tourism minister over the £4.7m unpaid tax bill of her husband - a film star and former nightclub singer. In the UK, the civil service receives substantial benefits, which are being eroded as a result of the crisis. Their situation is not nearly as favourable as that enjoyed by servants of the state in Greece.
The UK has substantial international trade and considerable receipts from providing services to foreigners. Whilst Greece has a useful source of income from the shipping industry, its significance is nowhere near as large as that of the UK overseas sector.

Much smaller role for UK consumers

This scenario means the consumer in the UK will be forced to play a smaller part in growth going forward. Companies on the periphery of consumer preferences will be hit severely during the change. Naturally, those businesses offering good service and competitive costs will prosper the most. We have already seen this adjustment both in the stock market and in the results of a number of companies, including those forced into administration and liquidation.

The largest proportion of UK exports goes into Europe, which is still suffering from the recession. European capacity to purchase our goods has reduced, hitting the forecast growth of total exports. Now that severe budget cuts are becoming the rule in European markets they will have even less capacity to purchase UK goods.

In these circumstances, most businesses will seek to direct marketing efforts to other areas of the world, particularly Asia and Latin America helped in no small part by weaker sterling. Such a change in strategy takes time to implement, but we expect UK exports of goods and services to recover strongly well into 2011.

The depreciation of sterling also makes the UK a very competitive place to do business in services and manufacturing. Consequently, we expect a considerable amount of inward investment over the next few years. The only proviso to this assumption is that the government provides tax incentives for capital investment and inward investment by foreigners. The published intention to assist the SME sector is also good news.

OVERSEAS

China stimulus drives infrastructure and raw materials

China has made the biggest difference to the shape of this recession compared to previous downturns. The Chinese have been able to flood their economy with cash, both from the government and the banking system. During 2009, lending rose by almost 30**%** whilst government spending on infrastructure has rocketed with the 4 trillion yuan stimulus package which started last year. This massive stimulus has ensured that growth has continued at a rapid pace so far this year

The Chinese knew they would be spending enormous amounts on infrastructure projects over the next few years so, at the beginning of last year, they decided to use some of their enormous foreign exchange to buy extra supplies of raw materials, particularly copper, iron ore and coal. It was a shrewd decision, considering the knockdown prices which were prevalent at the beginning of last year. In some cases the price of these metals has more than doubled since early 2009.

But China risks property bubble – hence recent curbs

Unlike in the West and Japan, where flooding the market with money has been of limited use, the Chinese economy is still in an early stage of capitalist development and the big monetary stimulus has increased activity substantially. Naturally, this cash infusion has led to a rapid rise in asset prices, initially stocks, followed by property prices, both commercial and residential.

As a result, speculation in the residential property market has led to draconian curbs on lending. Henceforth, the Chinese will not be able to own three homes! There is also a ceiling on the amount of credit available for residential loans in various areas. Finally the Chinese have also attempted to rein in lending across the board by tightening reserve requirements for the banks and by increasing the reserve requirement of the banks (RRR) three times since the start of the year.

China – slower growth ahead

Chinese growth in the first quarter was an exceptional 11.9% and most forecasters expect this number to fall gradually as the year progresses. It is unlikely to descend below 8% in the foreseeable future - the Chinese must maintain growth in order to mop up the annual increase in population and find them jobs. But there will be a hiatus in the number of adults of working age over the next twenty years as the one child policy has more impact. This will allow the authorities to try and upgrade the manufacturing base towards less emphasis on employment.

We also must take into consideration the extent of recent change in the Chinese economy. As recently as five years ago, there were just two subway lines in Beijing. Today the capital boasts twelve. By any measure this is extremely rapid growth. Considering, in addition, the growth which was necessary to provide accommodation and facilities for the Olympics, there is a good case for a decline in Chinese growth as some of this excessive infrastructure stimulus is withdrawn.

Consequent softer demand for base metal, iron ore and coal

Chinese demand for the main metals is now much larger than that of America. As they cut back on residential development, overall demand for copper will fall irrespective of the increase in American house building, which will gather pace over the next few years. Over the last year the price of nickel has doubled, which is due to the big expansion in Chinese steel production. However, some of the increase in iron ore prices will be trimmed as producers find it harder to pass on the full extent of the increases.

The Chinese have also developed their motor industry. The government forecast that total purchases of automobiles over the next few years will be in the region of 17 to 18 million. This is far more than recent numbers sold in the United States. In March alone nearly 1.3 million vehicles were sold in China. This is similar to the number sold in Brazil last month and exceeded sales in the United States.

Brazil and other BRICs

The Brazilian economy continues to grow. Whilst there is an inflationary risk, the capital markets have performed very strongly. The Brazilians have extensive natural resources, and an enormous worldwide export trade. Brazil and China represent one of the most important economic partnerships in the new global economy, with Brazil sending a great deal of raw materials to China and China sending back a large amount of finished and semi-finished goods.

One of the most impressive results of the current recession has been the increased importance of the BRIC economies, namely Brazil, Russia, India and China. They recovered much faster than the old world and continue to grow at a faster pace. Over the last decade Japanese growth has been very poor, but China has steamed ahead. This meant that China is now set to overtake Japan and become the second largest global economy.

The Indian economy also recovered rapidly and Indian industrial production has been running in the mid teens over the last few months. This has revealed some serious bottlenecks and wholesale price inflation has almost reached the 10% level. As a result, the Reserve Bank of India increased interest rates on three separate occasions over the last few months. It appears interest rates in India will rise further until inflation subsides.

Conclusion

The sovereign debt crisis is a natural development of the credit crunch and it may rumble on for some time to come. Markets now take very little on trust. Politicians have to deliver or be squashed. Risk aversion has risen and this will delay a proper recovery, however the following market framework is still relevant:

1. Asian markets continue to prosper, but they need American recovery to strengthen to compensate for a modest slowdown in China.

2. American growth will surprise positively; we in Europe ignore the robustness of American capitalism at our peril.

3. Latin America will do well, whilst America grows.

4. The natural resource countries; Canada, Australia, OPEC will all benefit from higher raw material prices than in 2009. Their currencies will remain strong.

5. The current volatility will present many opportunities in the UK and Europe, whilst the US and Asia will lead the way.

6. Equities remain inexpensive both against recent history and against other asset classes. We intend to use the dips to increase our exposure in many of the areas mentioned above.

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